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A JOURNAL ON CORPORATE GOVERNANCE & LEADERSHIP

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WHAT REPORTS SHOULD THE BOARD EXPECT FROM THE CFO

Financial reporting requirements are innately crucial to any Board and C-team to help evaluate past performance and inform future strategy. The common notion is that the CFO is responsible for providing accurate and timely reports in accordance with accounting standards (GAAP or IFRS).

Generally speaking, the rules and guidelines for financial reports are laid out by the Accounting Standards. External auditors reviewing the books use the resulting framework to form the basis of their opinion on the company’s compliance. IFRS (or GAAP) require the disclosures of incidents relating to changes in accounting and presentation, which are made known at year-end in the financial statements. Nothing in that remit process reveals the position of the company within the context of relevant business-critical factors, nor was it designed for that purpose. In fact the Accounting Standard has a generalist design to cover all types of business. It is the most common denominator from which to judge one company on equal footing with another. The GAAP is designed to be broad in nature to ensure coverage of all possible scenarios, and intended as a tool to benchmark performance across different industries and geographies. Although IFRS/GAAP have constantly evolved, encompassing more disclosure and details, there will always be a case
for business leaders to acquire additional insights and information.

Focusing on the Middle East in particular, there is a prevailing belief that the role of Finance is primarily the preparation of Financial Statements for the purpose of review and signature by the External Auditor. This misjudgment consequently reduces the role of Finance and confines the CFO to daily operational chores. There could be many reasons for this singularity: for instance, the absence of company taxation has traditionally relieved privately held companies from the need of establishing an accurate and timely formal reporting mechanism. Also, first-generation companies and sole-proprietorships don’t feel the obligation to hold formal financial records unless they need to approach banks for funding (Even then, most funding discussions are commonly driven by the Chairman of the Board or Vice-chair). There is therefore, a general supposition that a simple accounting department capable of reporting cash-position and P&L is sufficient for the job. Moreover, the growth of regional companies has been organic, with relatively few cases of mergers or acquisitions. Thus the niche for sophisticated and accurate financial reporting has remained primarily confined to listed companies and government held organizations, with the exception of large family- owned 2nd - generation businesses.

However, amidst an increasingly complex financial environment, reporting is becoming more and more comprehensive, requiring the inclusion of diverse global factors such as: Environmental considerations, corporate social responsibility, increased transparency, stakeholders activism, Legal compliance, and other Economic considerations such as taxes. An integrated reporting framework has become the norm for publicly traded companies and government-related entities. As the pressures from shareholders increased post the 2008 financial crisis, access to capital has proven highly correlated to rigorous reporting standards, both comprehensive and independent.

By way of example, Apple, the largest tech company, comprehensively displays financial and quantifiable data to provide notice that it has fully met its’ obligation under SEC and GAAP rules:

1) The yearly 10K report shows compliance with SEC, elaborating risks, legal proceedings, safety disclosures, stockholder matters, executive compensation, management discussions and financial statements.

2) Quarterly reports and Data summaries (mainly presented in number format) comparing the overall financial position to that of the previous quarter/year.
Similarly, Mitsubishi corp. provides a comprehensive 120 page integrated report. Yet, despite this vast amount of material in the public realm, analysts following the company’s performance are regularly in touch with management fishing for more information, normally privy to CEO or Board only. This exemplifies that, despite the presence of standardized fully compliant accounting reports, the need for insider and operationally specific reports is a must in order to fully understand a company’s situation. Because the Board cannot only rely on the accounting document to do its job, it must obtain information designed for decision-making purposes. The Board seeks data that is not merely relating to the past, but that can illuminate the facts, revealing possible ways forward. Information gathered by the internal business analyst, should be tactfully placed under the auspices of the CFO, who in turn, can summarize and professionally prepare objectively unbiased reading material for the Board.

Whilst the norm for public companies to club reporting and all associated functions under - the CFO to oversee the information gathering process, the same is not necessarily evident in private companies, particularly in our region. A company’s survival ultimately depends on the effectiveness of its board’s decision-making processes. But boards don’t exist in a vacuum. In order to make astute decisions, directors must have access to good-quality, timely information as to how their businesses are performing. The quality of performance reporting to Boards is therefore one of the key factors affecting companies’ competitiveness. Furthermore, Managers need to gain an understanding of the information needs of the Board and to consider performance reporting as a strategic extension of day-to-day information-gathering. The information and decision support that Board members receive will enable them to discharge their duties in an effective fashion.

As best practice, it is advised that all-inclusive reporting mechanisms within the company are duly assigned to the CFO, who leads the entire reporting process. Because reporting is very specific to each company, directly correlating to performance and KPIs, it is essential that the Board obtain feedback from an objectively unbiased source, which wasn’t involved in the establishment of the Strategy itself. Once this is achieved, the Board must enforce the process for objective and independent reporting to secure the up-flow of unbiased information.

Hence we argue in this article for a primordial evolution of the CFO role in the Middle East from its current framework (accounting, liaison with external auditors, and overseeing internal controls). To reap the full potential of the CFO position, internal decision-critical reports must be entrusted to them alongside traditional reporting. This completely subverts the prevailing CFO job-description, and requires him or her to step-up to the role of business partner, guiding and ensuring the delivery of the promised strategy. The role would go beyond mere compliance, and extend to forward-looking forecasting, sustainability, risk-management, and corporate social responsibility. Performance reporting is a means to an end, never an end in itself. The purpose of information is to promote action. The board report is therefore the document that pulls together all the relevant information with balance and objectivity. A good report should contain all the information necessary to facilitate decision-making at board level. It should lead directors to ask the right questions and initiate a chain of actions that will enhance the ability of the enterprise to achieve its short- and long-term aims and create sustainable shareholder value.

The contents of the CFO report to the Board could include any or (all) of the below:

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Given the substance and impact of the above on the company’s performance and the Board’s decision making, we cannot over-emphasize the importance of independent reporting, and the need for the Board to own and closely monitor this process. The audit committee has the mandate to oversee this process and the duty to ensure that Finance has the right mix of independent processes and capabilities to provide complete and unbiased information to the Board. I can personally attest to the effectiveness of presenting such types of additional information to the board alongside traditional reports.

The comprehensive nature of this information might require the Board to step-in and secure a culture of openness within the company, as a prerequisite to effective internal reporting. It is imperative that a proper mechanism within the organization is created with sufficient control to secure the reporting of inevitably commercially sensitive data without endangering its proliferation. Some people in the industry already predict that soon we will be in a world where a single database exists to communicate both internally and to stakeholders. It is an interesting vision on transparency, but the above commercial confidentiality issue remains a challenge.

In conclusion, regardless of where a CFO sits within an organization, we recommend he or she should be spending more time ensuring that the Board understands the company’s strategy and value creation in the context of the financial reports. A CFO must forge an effective relationship with the Chair of the audit committee, and be assertive in anticipating queries from the Board. In their eyes the essence of a valuable CFO rests on their ability to assemble an objective view of the business’s performance by comparing it to the relevant market using adequate benchmarks. Additionally, the CFO has to explain to the board the anticipated future performance and the suitable resource allocation for increased business growth. They also need to keep a lookout on potential M&A, whilst adequately factoring for potentially disruptive transformations, such as digital technology opportunities.
Financial data is not the only information that boards need to receive on a regular basis. Companies are increasingly realizing that they also need data that provide insight on the culture prevailing within the company as part of their effort to understand and manage risk.

The Chief Financial Officer may be involved in the collection and preparation of some of this data, and where the board does not specifically include a conduct, culture or risk committee it is most likely to be processed initially through the audit committee. However, human resource, internal audit and compliance departments will also play an important role.

Boards need to understand and shape what drives behavior in their company because inappropriate behaviour can vastly increase risk either through reputational damage, regulatory sanction and actual losses. Examples include corruption, inhuman labour practices, a negligent approach to health and safety and lax financial controls.

VW needs to know not only exactly what happened when its software engineers cheated on emissions tests, but also why they were driven to do this. Otherwise it cannot address the issue properly or protect itself in future. Keeping a closer check on culture would have helped it.

There are a number of indicators that provide insight on culture. In the human resource area these include staff turnover, absenteeism, responses to employee surveys, whistle-blowing, exit interviews and social media traffic. In the customer area they include customer satisfaction data and the record in resolving complaints.

Where suppliers are concerned, they include willingness to maintain the company’s expected standards of behaviour and the state of morale. Bribery does not just involve governments. In some countries where food retailers have faced quality scandals, one of the problems has been that the company’s executives have been bullying suppliers to the point of extracting bribes from them.

Three principles should guide a company’s approach. First, rather than try to monitor everything, the board should put together a dashboard of relevant indicators which will help them understand the prevailing culture in their business and then ensure that they are properly informed.

Second, each piece of information needs to be properly analysed and boards must join up the dots so that the connections become clear. For example a high level of customer complaints and a high staff turnover indicate a serious problem.

Third, forward-looking indicators are particularly useful. These include health and safety incidents where someone might have been seriously injured or even killed but where no one was hurt. Employees are often tempted to suppress these but it is imperative that boards are informed about these. Similarly chronic equipment failure is a big risk. It suggests poor management and the risk of serious industrial accident. Another indicator of potential trouble is where capacity use is erratic.

Getting all this right involves some effort both on the part of boards and of those charged with assembling the information. However, this is as nothing to the effort which has to be applied when disaster does occur.