The 6 Secrets of a successful CFO - Part I

Achieving financial success for your company

FOREWORD

This does not aim to be an academic manual (this being an area already covered by top-flight writers). Instead, it sets out to highlight the types of behaviour that Clarkson Hyde Professionals come across most frequently in the companies they work with, whilst highlighting simple factors which, if successfully harnessed, can prove particularly valuable for companies, without requiring major effort.

In this edition of Food for Thought, we will look at the first three secrets of a successful CFO and in the next edition, we will cover the final three. We hope you find these insights useful.

INTRODUCTION

Each nation has within it great entrepreneurs who tend to focus on production or commercial skills, whilst placing lesser importance on financial aspects.

The reason probably needs to be sought in a system traditionally based on access to bank credit. This method has never placed much emphasis on the financial plans of companies, whilst instead tending to rely on the ability of the entrepreneur to provide property or bonds as forms of guarantee. In other words, what counted was whether the businessman in question was solvent, rather than gauging whether the business itself was healthy.

Things today have changed. The entire world has literally changed. The mechanism which for decades has ensured the success of small-scale family capitalism, often rooted in craftsmanship or manual work and relying on highly specialised product skills (often proving more successful than international counterparts) is now being forced to confront a new, hard-to-control scenario.

In a system which revolved around skills it was possible to stand out from the crowd if you were good at your work and knew how to turn out a better (or cheaper) product than that of your competitors, and if you knew how to sell it well. Finances looked after themselves; that was what the banks were there for. Nowadays, entrepreneurs are finding that finance has become a key variable that can bring success, or declare the death of their businesses. Adapting to this situation is hard: entrepreneurs are often short of financial knowledge, as they have failed to cultivate it over the years. Moreover, their take on company organisation often tends to give the financial manager insufficient jurisdiction to provide solutions for problems".

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SECRET 1
TRY TO LEARN WHERE YOU ARE EARNING AND WHERE YOU ARE LOSING OUT!

When we go to companies, we often realise that they are not entirely aware of which product lines are profitable and which are unprofitable, or even making a loss.

This often happens because they forget the **indirect production** or **sale costs**, or the **structural costs**, or because these are not properly allocated to the individual product or service.

On closer inspection, one realises that a product, even if sold at a very high price (which seems to make it profitable), absorbs many indirect production or sale costs. So companies are often losing money where they think they are earning, or vice versa.

A product sold at a low price but which has completely amortised the production investments, or which does not call for any major commercial effort to distribute it, can end up being more profitable than the presumed "star" of the portfolio. By the same token, products that do not appear profitable at full cost can help cover fixed costs – which cannot be eliminated – making it necessary to keep making and selling them.

There are many cases of this kind. The problem of correctly allocating product costs not only involves analysing company results, but also and indeed above all, how **prices are calculated.** Whilst they are without doubt highly influenced by market dynamics, they cannot be reckoned without an objective initial assessment of the economic effort needed to generate the product.

This is particularly true in sectors where the cost of the raw material varies a great deal, owing to rapid fluctuations in the market, or where the indirect production or structural costs account for a great deal, or where a single production line can be used to produce different products. It is vital for the product cost to be carefully analysed and monitored to ensure the value is not unwittingly destroyed, instead of being generated.

To conclude, if we are to avoid being guided exclusively by the market when calculating sale prices, and losing sight of whether they are managed on a cost-effective basis, it is essential for companies to have a **management control** system. By harnessing a precise system for assigning costs, this makes it possible to ascertain product margins properly.

We have worked with many clients in this area, helping them to get a complete picture for their management decisions.

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SECRET 2
PREPARE A CASH FLOW PLAN!

The cash flow plan is one of the most important documents of all, yet many Italian companies do not have one. In many respects this is surprising because cash flow – in terms of liquid funds – is the most crucial element in running a company: businesses prosper or go bankrupt because of reasons linked to cash flow.

We need only recall that manuals define the state of bankruptcy as a situation in which an economic entity, usually an entrepreneur, is unable to duly honour his or her obligations at the set deadlines, using normal payment means.

Cash is king, as the Americans say, meaning that cash is what commands company dynamics. But perhaps this motto, written by a friend and General Manager of a private equity fund on the office wall of the Managing Director of a subsidiary company, is clearer still: *Revenue is vanity, profit is sanity, cash is your reality.*

Your cash flow plan is without doubt one of the most complex forecast documents to draft: it sums up how the company is managed overall, as every operation has cashflow consequences and accordingly deserves the full attention of the entire organisation. It is a fundamental document which can give companies invaluable information, in spite of the fact that often, in drafting it, companies realise they do not have complete control over internal information flows, particularly those used for forecasting.

When a **cash flow control system** becomes fully operational, a strong element of **performance improvement** is incorporated by the organisation: sales staff, for example, have to provide more detailed forecasts of cash collection and will accordingly go that bit further to chase up clients; the purchasing manager provides more precise payment forecasts; those planning stock repurchase levels dedicate more attention to improving rotation. As a result, every internal cash generation process can be managed in a more focused way.

Proper **cash flow planning**, particularly in situations of tension, **allows** managers **to focus on strategic activities**, so they can avoid "playing it by ear" and forever finding themselves in the midst of a financial emergency.

The market also offers excellent instruments for "cash management" at relatively low costs. Nonetheless, in order to be used to best effect, they call for specific skills and, above all, thorough procedural management of the company's real and forecasted flows.

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SECRET 3
BE CAREFUL WITH INVESTMENT IN WORKING CAPITAL!

Working capital is the difference between assets and liabilities in the short term. The former includes, by way of example, accounts receivable from customers, advances to suppliers and stocks of finished products, as well as items in production and raw materials.

The liabilities include items such as outstanding amounts owed to suppliers and employees, as well as recurrent taxes. In practice then, everything an enterprise needs to conduct its business.
Almost always, it is the **most important investment the company makes**, but often it is also the most overlooked.

In our experience, many companies fail to dedicate much attention to managing investment in working capital (in particular in receivables or stocks), and as a result accumulate a large amount of the value generated in uncollected receivables, or stocks that are produced but not sold.

It is wise to bear in mind that in many sectors, the value of working capital deteriorates surprisingly quickly (think of stocks of technological or fashion-related products as well as receivables).

In Italy, in particular, the topic of receivables is of particular importance because the instruments companies have for recuperating outstanding receivables are notoriously ineffective. As a result, it is necessary to manage assets properly beforehand, when giving credit to customers, to ensure there are no unpleasant surprises further down the line.

Even where the management of outstanding sums and DSO has yet to reach pathological levels, proactively managing such a delicate area can yield unexpected benefits. By way of example, these can be summed up by this simple numerical illustration of Company A, a typical Italian SME:

- Monthly turnover: € 2,200,000
- Daily turnover: € 100,000
- Annual turnover € 26,400,000
- Average days taken to collect outstanding amounts owed (DSO): 92 days

Reducing the DSO by just 10 days would create available cash flow totalling €100,000 x 10 days = €1,000,000.
At present, obtaining a one million-Euro bank loan is a titanic feat for the average SME. Yet all it takes to reap enormous immediate advantages is just a few measures and greater awareness of trade receivables.

In summary, whether you realise the need to understand the profitability levels of your products or services, your business' cash flow control would benefit from review or your require working capital management advice, we are here to support you in creating systems and controls to ensure your business is in optimum financial shape.

Please call your usual **Clarkson Hyde Global** partner contact if you'd like to arrange a time for us to meet with you.

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