FINANCIAL FUNDAMENTALS FOR DIRECTORS

2nd Edition

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S. Dianne Azoor Hughes

Australian Institute of Company Directors

The Australian Institute of Company Directors is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 44,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

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Australian Institute of Company Directors
18 Jamison Street
Sydney NSW 2000
T: 61 2 8248 6600
F: 61 2 8248 6633
E: publications@companydirectors.com.au
W: www.companydirectors.com.au

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Foreword

When the first edition of *Financial Fundamentals for Directors* was published in 2014, we observed that the world in which we then lived was growing more complex. This trend has accelerated since then and many directors in Australia acknowledge that it is becoming even more difficult for them to deal with the increasing complexity of financial statements.

At the time of the first edition, legal decisions, such as the *Centro* case had confirmed, among other things, that directors cannot delegate to the audit committee, and others, their responsibility for approving the statutory financial reports. Directors must read the financial statements and consider whether the disclosures they contain are consistent with the director's own knowledge of the company's affairs. More recently, as community expectations of transparency and compliance have risen, fueled by situations such as those identified by the Hayne Royal Commission, the role of directors as stewards of the enterprise has been brought into stark relief.

Into this environment, changes to accounting standards that deal with matters such as revenue recognition, financial instruments, loan loss provisioning and lease accounting have added considerable complexity to the preparation and look and feel of financial statements. The preparation of financial statements is now dependent on many more judgements and assessments of value that need to be appropriately documented. This has added to the perception of many within the director community that disclosures are becoming more complex and difficult to understand.

It is not necessary, and it would be unreasonable to expect, that all directors need to be 'financial experts'. However, they must be sufficiently financially literate to satisfy themselves that they understand the results and financial position of the business and are able to fulfil their statutory obligations. Importantly, they need to know when to ask for expert advice.

This updated publication of this book by the Australian Institute of Company Directors is a timely contribution. As author of both the first edition and this revision, S. Dianne Azoor Hughes, a former member of the Australian Institute of Company Directors' Reporting Committee, has produced a book that aims to help directors when reviewing financial statements and includes, inter alia, a schedule of over 100 questions for directors to consider.

No single publication can provide all the answers to the complex world of financial reporting. However, this book should help all directors, whether seasoned financial professionals wanting a contemporary view on accounting, or non-accountants hoping to better understand the financial reports.

Michael J Coleman FAICD, FCA, FCPA
AICD Board Director, AICD Audit Finance and Investment Committee Chair,
AICD Reporting Committee Chair
Professional non-executive director of publicly listed, not-for-profit and government enterprises
Adjunct Professor of Business, Australian School of Business
University of New South Wales

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Finding a balance between explaining financial fundamentals and more advanced financial learning is not a straightforward task. I am grateful for the insights they shared through their careful and pertinent review of the revised draft, which have had an important impact in the final publication.

I also thank my publisher Javier Dopico GAICD for his timely input and modifications to the 2nd edition.

Chapter 1

Financial literacy and governance

1.1 Introduction

When a nominee is invited to join a board, the company's constitution and most recent annual financial report will be two primary sources of information that accompany the offer. The constitution will provide a basic outline of the company's governance, including its financial governance structure. The financial report will provide a deeper insight into company performance and areas of both operational and financial risk over the preceding two years. To make an informed decision to accept or decline an offer to join a board, a prospective director will have an interest in the company's financial report. A prospective director needs to be able to read and understand a financial report to evaluate whether the underlying risks are acceptable in making a decision to join the board. The decision to accept or decline a board position is likely to present the first point of contact with a company's financial report; this information provides context for financial responsibilities in a future role as a director of that company.

In general terms, 'financial literacy' refers to the skills and knowledge that enable informed and effective decisions to be made about the use of financial resources. An individual is expected to have a level of financial literacy sufficient to manage their income and expenses, to protect any assets acquired and to pay their bills when they fall due. The level of financial literacy expected of directors is much higher than the expectation of financial literacy in the general population. A director of a company is expected to have a level of financial literacy that is commensurate with the operational and financial risks of that company.

Directors need to consider whether they have the appropriate skills and expertise to balance risk effectively and drive performance, and to be able to establish financial management practices appropriate for the company's particular circumstances. A nominee for a not-for-profit board is likely to require a different set of skills to a director of a for-profit company. Understanding risk management includes financial literacy as it enables a director to steer companies and organisations through both boom and bust cycles.

For example:

- The operational and financial risks of a start-up are very different to those of an established public company.
- If a company operates across borders, directors will need a level of financial literacy that includes an understanding of the differing economic environments and regulatory requirements for regions in which business is conducted.

Directors should have an appropriate level of financial literacy to meet their legislative responsibilities, understand the company's financial information needs, and recognise when consultation with a financial expert is needed. At a very basic level directors need a clear understanding of the differences between profit, cash flow and going concern, recognising that profit is not an absolute number and will be impacted by the valuation methodologies adopted for financial reporting purposes.

1.2 Statutory responsibilities

A director of a company is expected to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they held that same position of responsibility. This is the general duty of care and diligence as set out in the *Corporations Act 2001* (Cth) (the Act). Financial literacy is just one aspect of a director's duty with respect to the corporation — but it is essential in order for directors to meet their statutory obligations to avoid insolvent trading by ensuring the company can pay its debts as and when they fall due.

Company directors are required to comply with the statutory obligations set out in the Act and a lack of compliance could result in financial and other penalties. For instance, no director, regardless of the type of organisation, and whether paid or voluntary, can delegate their responsibilities to approve and sign off on the company's statutory financial reports (which are prepared in accordance with Australian Accounting Standards) to other directors, company officers, financial experts, or any party (refer to **section 3.3** for more information on financial information provided for external reporting).

While director statutory obligations have not changed, there have been several court cases over the past two decades that have highlighted how vital financial literacy is, and how severe the consequences can be when it is lacking.

The *Centro* case of 2011[1] was important in reiterating directors' statutory responsibilities. While directors are entitled to delegate the preparation of the accounts and the day-to-day operations of the company to others, the directors have specific responsibility under the Act to approve the financial statements. This responsibility cannot be delegated to management or the external auditors. Middleton J stated that each director is expected to "take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her".[2] Further, omissions in the relevant financial statements were not a "mere technical oversight"[3] but "were matters that could have been seen as apparent without difficulty upon a focusing by each director, and upon a careful and diligent consideration of the financial statements",[4] and in the circumstances, each of the directors should have enquired further into the matters revealed by the financial statements. Among several other aspects, the court dealt with a misclassification of significant borrowings as 'non-current' that should have been classified as 'current' in Centro's 2007 financial statements. Middleton J found that each of the directors had essentially failed to take all reasonable steps to focus on the content of the financial statements and consider it for themselves, particularly the short-term debt.

In 2017, the Federal Court of Australia disqualified the managing director of Banksia Securities Ltd (Banksia) from managing corporations for a period of five

1 *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291; [2011] FCA 717.
2 *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291; [2011] FCA 717 at [20].
3 *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291; [2011] FCA 717 at [10].
4 *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291; [2011] FCA 717 at [23].

years.[5] The court declared that he had contravened s 344(1) of the Act by failing to take all reasonable steps to ensure that the financial reports for Banksia in 2011 and 2012 complied with accounting standards to give a true and fair view of the financial position or the financial performance of the company. Further, the managing director failed to have or to obtain a sufficient understanding of AASB 139 *Financial Instruments: Measurement and Recognition* for the recognition and impairment of mortgage investments made by Banksia.

More recently, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry called into question the financial management and lack of adequate oversight by directors and senior executives of major financial institutions, including the Commonwealth Bank of Australia and AMP.

1.3 Financial literacy

Financial literacy encompasses a combination of skills, background and experience. For company directors, financial literacy is largely about the ability to:

1. acquit formal legal and statutory obligations as they relate to financial matters, such as signing off on the annual financial reports;
2. monitor financial results to assess solvency;
3. balance risk mitigation (financial and otherwise) with the ability to drive the company's financial performance by understanding the 'story' told by its financial reports; and
4. know when financial experts are required to assist with the above points.

While these are the four pillars of financial literacy, other factors may shade the depth of financial skills and knowledge needed, such as:

- the company's business model;
- business plans and strategy;
- stage of growth;
- the company's financial health;
- risk profile;

5 *Australian Securities and Investments Commission v Godfrey* (2017) 354 ALR 536; [2017] FCA 1569.

- the skills mix around the boardroom table; and
- the economy.

1.4 Financial literacy vs financial expert

A board will comprise directors with various skills relevant to the company's business. In addition, each director should have an appropriate level of financial literacy, and the board should have at least one director, or an adviser, who is a financial expert. A financial expert can identify and action the most appropriate accounting treatment in a given set of circumstances. A financial reporting expert can choose and apply the correct accounting framework. Accounting frameworks explain *when*, *why*, *what* and *how* transactions should be described in accounting terms in a financial report. Several different accounting frameworks exist, and the applicable accounting framework will not be the same in all circumstances.

The financially literate director is not expected to have an in-depth knowledge of different accounting frameworks or have the ability to action the required accounting treatment. Instead, a financially literate director should be satisfied that the accounting framework required in the circumstances has been applied. He or she should also be able to understand *when* financial expertise is needed, and *why* a particular course of action has been followed.

Financial reporting is a language used to explain business activities in financial terms. Directors should have an in-depth understanding of business activities and must have confidence 'the story' portrayed in financial terms in the company's financial statements is consistent with their understanding. The ability to read and understand this 'story' is at the heart of a director's financial literacy.

Commitment to lifelong learning

The business environment is dynamic and a company's business activities are likely to expand and contract in response to changes in that environment. Changes in the economy and the business environment drive changes in financial reporting requirements and financial reporting changes are often delivered in response to new developments. For each company, business activities will evolve over time. As such, the nature of the company's financial reporting requirements will also evolve.

For example:

A company starts life as a small proprietary company and over the years, grows to become a large proprietary company. It then changes status to a public company for an initial public offering. After establishing itself as a listed company, it then diversifies its operations.

Each new status in the life of the company is likely to introduce additional financial reporting obligations.

Companies may remain at a stable level of operations or may actively seek new opportunities. However, no strategy is risk-free and inevitably companies will take action to mitigate risk or simply agree to accept and monitor perceived risks with no immediate action taken. Companies are unlikely to operate in isolation; they are likely to have suppliers, customers, employees and perhaps even communities that are impacted by their activities.

A company's strategies, business activities, risk mitigation and relationships are captured and explained in the financial statements, both in the numbers reported and in the disclosure notes. As each of these factors evolve and change, the 'story' told in the financial statements will also evolve and change. Directors should remain alert to recognise the impact of change in the business environment and changes in the size and nature of the company's operations. A commitment to lifelong learning is needed for directors to match financial reporting information with their knowledge of business developments.

1.5 Financial governance

The Australian Government's business resources website includes a straightforward description of corporate governance as being "good decisions being made by the right person".[6] This principle can also be applied to financial governance,[7] which is an

6 Australian Government, 2018, *Setting up a corporate governance structure*, [website], 14 August, https://www.business.gov.au/planning/business-structures-and-types/business-structures/set-up-your-governance-structure (accessed 15 April 2019).

7 The Australian Institute of Company Directors has a range of courses, including the *Company Directors Course*, which includes finance modules, and other courses specifically designed to improve financial skills for directors, such as *Mastering Financial Governance*. Refer to Australian Institute of Company Directors, 2019, *Courses for the director*, [website], http://aicd.companydirectors.com.au/education/courses-for-the-director (accessed 15 April 2019).

essential element of a company's overall corporate governance systems and processes to ensure it meets its financial obligations to shareholders, financiers, government agencies and other stakeholders. Financial governance provides the link between the company's operations, carried out in accordance with its business model, and reporting performance for both internal and external purposes. An understanding of financial performance provides directors with an insight as to whether or not the business model is capable of achieving the results anticipated.

The primary areas of financial governance are:

- strategy;
- financing;
- reporting;
- monitoring; and
- solvency.

Financial governance also includes the company's responses to key issues and financial risks that arise at each stage of the company's lifecycle. It will also determine how financial decisions are made on a daily basis, ensuring there is an appropriate level of authorisation and oversight, depending on the extent of risk associated with the nature of the transaction.

For example:
Routine transactions are likely to be approved by managers with appropriately delegated authority, whereas complex and unusual transactions would often require board approval.

Financial governance includes the response to reporting obligations, both internal and external, and the consideration of the critical financial issues and risks that are implicit in those processes. For directors and boards, ensuring that good decisions are made by the right person includes identifying the expertise and capabilities required to carry out different financial roles within the company. Depending on the complexity, the financial skills and expertise needed by the board and senior executives may range from basic book-keeping to an in-depth knowledge of technical accounting requirements.

Financial governance includes oversight of:

- the employment of appropriately skilled persons;
- consultation with external professionals as needed;
- the selection of external advisers with appropriate expertise and experience; and
- the continuing professional education of financial staff employed by the company.

In a small company without complex transactions, financial governance may involve establishing systems and processes to record transactions when they occur and to monitor cash flows on a regular basis. Monitoring cash flows might be as simple as ensuring revenue is collected promptly and debts are paid as and when they fall due. In these circumstances, the company may only require that staff have basic book-keeping skills. Budgets and cash flow forecasts, together with periodic accounts, are likely to be prepared with the assistance of an external accountant. For a small company, these procedures may be adequate to satisfy financial governance obligations.

In contrast, financial governance practices will be significantly more extensive in a large company with more diverse business activities and/or complex transactions. Customer invoicing systems will generally include more complex terms of trade, such as customer financing arrangements. Credit control activities may be required to ensure monitoring and collection of overdue debt. Goods and services might be supplied under a strategic alliance with a third party; they may be imported or exported and denominated in foreign currencies. The company may work more closely with its bankers to establish processes to mitigate foreign currency risk.

To manage more diverse business activities, a larger company will probably have a finance team led by a financial controller or chief financial officer. The board of directors will need to have a good appreciation of the nature and extent of the company's transactions to ensure the financial governance practices in place are appropriate.

Strategy

Different corporate strategies will have differing financial impacts, which in turn, drive the company's financial governance practices. Financial literacy encompasses understanding the financial implications of strategy, including the associated risks.

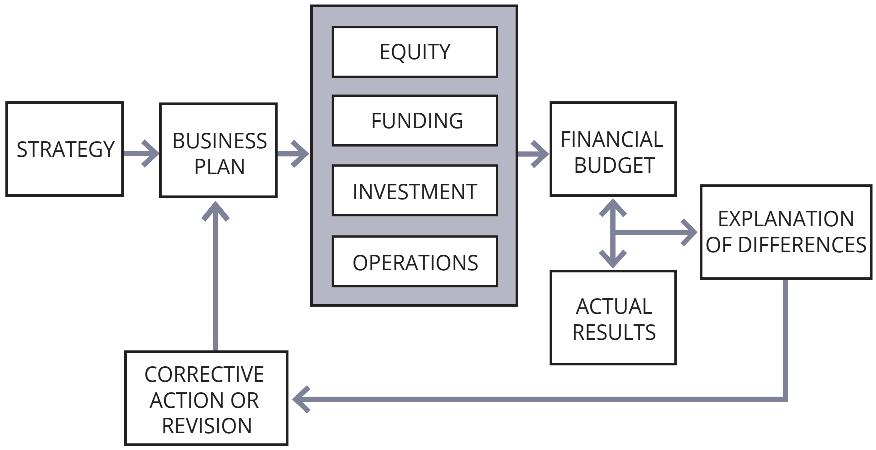
For example, the business model is explained in the corporate strategy in the business plan, which will include:

- sources of funding;
- funding limits;
- capital structure;
- cost of capital;
- cash flows;
- return on investment;
- dividend decisions; and
- impact of the accounting standards on the recognition and measurement of transactions.

The company's strategy and financial plans should be closely aligned with each other. The business plan, prepared to implement the company's strategy, will form the basis for the financial budget. Examination of the differences between actual results and the financial budget will provide insight into whether or not the business plan for the year can be achieved (internal reporting is considered further in **Chapter 3**).

Financial governance ensures the business strategy includes an evaluation of the sources of funding available to the company to support implementation of its business

Figure 1.1 Corporate strategy and business plan



plan, assessment of the effectiveness of investment decisions, and the extent to which additional funding may be required at each stage of strategy implementation.

Financing

It is essential for directors to consider how the company will be funded, and often funding is provided through a combination of equity and debt. For example, when a company first starts in business, capital investment will be provided by the purchase of shares in the company. Incremental growth is likely to be supported through funds generated from operations. In contrast, as the company grows, and new projects/ventures are introduced, other sources of finance might be introduced. Each year, the directors will also decide whether profits are retained in the company or returned to the shareholders by declaring a dividend. As business activities become more complex, good financial governance will often require a formal treasury management policy for foreign currency, interest rate hedging and other related matters. Policies for capital management and capital investment decisions may also be appropriate.

Reporting

Most companies have both internal and external reporting obligations. All companies need internal reporting to monitor performance and to provide evidence that the company is not trading while insolvent. External reporting obligations vary with the size and nature of the company and its sources of finance.

Public companies, large proprietary companies and small proprietary companies that are foreign-owned have statutory reporting obligations under the Act to present and approve annual financial statements that are prepared in accordance with Australian Accounting Standards to present a 'true and fair' view of the company. These companies are required to lodge their financial reports with the Australian Securities and Investments Commission, and thereby make them available to the public. Directors of listed companies have additional reporting obligations as set out in the ASX Listing Rules and must ensure that they are aware of the extent of their responsibilities, including continuous disclosure reporting obligations.

Companies also have reporting obligations to the Australian Taxation Office and other government agencies. Further reporting may be needed to external finance providers, such as banks, to satisfy reporting obligations under the terms and conditions of financing arrangements.

All financial information presented for board approval to meet company reporting obligations should be robust and accurate, without material error. Directors will want to be satisfied the company has established appropriate accounting systems and internal controls (matters relating to internal controls over financial reporting processes are described in **section 6.3**). These processes may include, or require, external auditing of the financial information presented for board approval.

Monitoring

Financial monitoring of the company's performance is a key responsibility of the director. As such, information presented to the board and management should facilitate this process and will include key performance indicators, cash flow forecasts and budgets. If the company is required to achieve certain performance criteria specified in debt covenants, the board should ensure that management monitors compliance with these criteria and reports regularly to the board to confirm there is no breach of the terms and conditions of finance.

Solvency

Directors have a responsibility to ensure the company is solvent and therefore able to pay its debts as and when they fall due. This means that directors must be able to determine if there are *reasonable grounds* to believe the company can pay its debts. 'Insolvency' is defined as the inability of a company to pay all of its debts as and when they become due and payable, as set out in s 95(2) of the Act. Section 588G makes it an obligation of the directors of the company to not trade while insolvent.

In order to determine whether debts can be paid as and when they fall due, reliable, accurate and complete financial records must be maintained by the company. In Australia, a failure to keep appropriate records is a prima facie indicator of insolvent trading and can therefore have serious consequences for directors, who will be deemed, prima facie, to have permitted the company to trade while insolvent (for a more detailed discussion about insolvency and its link to the accounting concept of 'going concern', refer to **section 4.3**). The nature and extent of business activity determines the nature and extent of accounting records that need to be maintained to demonstrate that the company's accounting records are adequate. In addition, when cash and bank balances are at minimal levels, a cash flow projection is essential to ensure that cash deficiencies can be identified ahead of time and mitigating action taken so that debts can be paid when they fall due.

1.6 Summary

Directors have a duty of care to ensure they have a level of financial literacy commensurate with the size and nature of the company's business activities. These obligations are set out in legislation and illustrated by numerous examples in recent case law.

Financial literacy is needed to implement financial governance practices that are appropriate for the business model in place. Directors need to be concerned with monitoring company performance to demonstrate they have reasonable grounds to believe the company can pay its debts when they fall due. Company performance is explained in both internal and external financial reports.