DAVIS & HODGDON ASSOCIATES

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Financial Reporting: The Key to Success!

Establishing an easily accessible and accurate method for managing your business' financial information is critical to success and profitability. The right reports and processes in place will allow you to make sound, swift decisions that will grow your business and provide you with the time to focus on the matters that are most important to you.

Accounting System 101—Why Bother?

In working with small companies one of the most frequent challenges accountants run across is a poor financial system. In the world of the daily grind, entrepreneurial business owners are so focused on daily operations that they often have no time for management system design or the analysis of their day to day operations. This is not to say that entrepreneurs are misguided; they are simply overwhelmed. The irony is that once established, these systems will create tremendous efficiencies and free up valuable time.

The ramifications of a poor financial system are many and easily compounded. A poor financial system results in a delayed reaction to negative trends and an inability to plan due to poor historical information. The result is exponential growth in negative consequences. Some common examples of negative consequences include:

1) Insufficient Return On Investment (ROI). Otherwise known as inefficient use of capital. This is money that has been invested in the company that has not produced enough profit.

2) Increased cost or lack of access to capital. If banks offer you a loan they will demand a higher interest rate. If investors offer you capital, they will require a higher return on their investment; often in the form of a larger stake in the business. As a result, there is less money in your pocket due to higher perceived risk resulting from "insufficient financial management".

3) Decreased Enterprise Value. Investors or potential purchasers will decrease the valuation of your company due to poor ROI, high cost of capital and lack of efficient systems.

4) Increased costs at tax time. A lack of planning results in additional taxes and penalties. Poor books at tax time require additional expenditures to clean them up.

5) Inability to make sound decisions. The bottom line—if you can't trust your financial data, you can't use it to make your business more profitable.

Review your personal goals, your goals for the company and your current financial system.

1) Develop a long term strategic plan for your business. Your strategy will be different if you plan to sell the business, pass it to your children through estate planning, or if you plan to phase yourself out of management and continue as an owner.

2) Ask your accountant for end of year tax planning. The process will educate you, keep your accountant informed and foster healthy discussions around your plans for the following year. The tax planning session will allow you the opportunity to make rational decisions that may help reduce your tax liability and enable you to plan for the inevitable payments.

3) Review your books on a quarterly basis. Quarterly reviews will ensure that you have good information to base decisions on throughout the year. Quarterly reviews will also ensure that there are no additional costs at tax time due to poorly-kept books.

The review can serve as one component of your internal control system; you and your accountant should be on the lookout for questionable practices or transactions. In the process, you will notice areas of im-

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provement, which can help you sustain the progress you have made. It is all too common for companies to cleanup their books, only to undo all of the progress made in the following months.

Create a rolling budget. The days of creating and strictly managing an annual budget are largely over. Given our immediate access to information and the dynamic nature of business today, successful managers are adjusting their budgets throughout the year to reflect the changing landscape. A rolling budget is not intended to correct the budget based on what's happened since you created it, rather it is meant to reflect material changes in your business environment and to help allocate resources in the best possible way to capitalize on inevitable changes. For example, if your company wins a large unexpected sale, you may have to reallocate resources to fulfill the contract or you may have extra available cash and decide to increase your marketing budget. Either way, you are not correcting what has happened in the past; you are simply adjusting your plan for the future.

Develop Key Performance Indicators & Benchmarks. Identify and begin to monitor 5 Key Performance Indicators (KPIs). The key is to be able to compare from period to period; one technique is to take the indicator (say cost of goods sold) and divide it by income. Track your cost of goods expense as a percent of income and compare multiple periods, better yet graph the percentages over time and you will have a clear picture of how your cost of goods is affecting profitability. You can then use the information to make decisions such as a price increase or a change of suppliers. Look for indicators that have a large affect on your business such as your largest expense or a particular revenue stream. Remember, not all KPIs will be financially based! You can use multiple indicators in conjunction to gain a solid understanding of how your business is performing, where it is going and where to focus your attention.

Benchmarks tell you if your KPI values are good or bad and serve as your guide to how your business is doing. There are three basic components to consider when developing benchmarks: historical levels, industry standards and company goals. Each of the three have individual importance when developing benchmarks, therefore it is important to make a concerted effort to consider as many sources as possible.

Generate regular management reports and USE THEM. You can set up user-friendly reports that you can update in minutes on a weekly, bi-weekly or monthly basis. One of the most common reports is a "Dashboard" or "Pulse Report". This report includes real-time financial and non-financial information; the pulse of the company! The goal is to have quick and easy access to information related to the most important areas of your business. The right reports allow you to quickly identify trends and make informed decisions.

Determine a hurdle rate for new projects or investments. Determine the minimum return on investment you should require when investing in your business (hurdle rate). To accomplish this, set up spreadsheets that will allow you to perform a quick return on investment analysis. Once you have this tool you can easily evaluate the "opportunity costs" by plugging in data related to other potential "opportunities" and know the return on investment for each new opportunity.

The key here is to set up the tools you need so you can efficiently manage your business. Once accomplished, be sure to put in place a system whereby you use each tool regularly. There is no benefit in having great tools that are not used. Budgets should be evaluated no less than monthly and management or "pulse" reports should be run no less than biweekly.

In summary, the reports you review, regular meetings you conduct, and all other data review functions you perform regularly are part of the financial management system. Document each piece of the system and put them on a schedule or timeline. The end result is a precise, time-saving and easy to use system.

Some examples of tools you can use regularly to manage your business include:

1) Management or "Pulse" Report
2) Annual Rolling Budget
3) Sales Summary
4) Cash Flow Report
5) Accounts Receivable aging
6) Visual Aids in the Form of Graphs

Davis & Hodgdon Associates entrepreneurial advisory services include assistance in establishing and using financial reports. With the right tools and a dedication to using them you are armed for sustained success. Implementing management reporting procedures is just one in a unique brand of services focused squarely on the needs of growing businesses. For more information call 802-878-1963.