Management-Focused Financial Reporting Systems In a Small Business Environment

What, Why & How to make it helpful and secure and gain a competitive advantage!

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This guide is designed to be used –the margins are wide on purpose. Write in them, make notes to yourself.

Give yourself reminders to apply the concepts to your specific needs.

What you do with what you know is totally up to you.

Chances are you're not an accountant[1] otherwise you wouldn't be reading this information and that already puts you one step ahead of your competition.

After all, isn't the desire to obtain a competitive advantage the reason entrepreneurs do most things?

This book is the result of the author's decades of experience designing and implementing financial reporting systems in small business environments. Following the advice of this book –which others have paid up to $250 an hour to get- will give you a competitive advantage.

[1] Unfortunately for their clients, many accountants already think they know it al; they have a one-size-fits-all approach to solutions, and then wonder why their clients complain and grumble about accounting services and fees.

Overview

If you're like many business managers, you may think that accounting is an expensive process incurred only to file compliance reports with the various tax authorities. For many companies, unfortunately, that's true. But it should not be the case.

Properly collected, categorized and retrievable financial information is a valuable resource which can be used for making the right decisions to assure your company's growth and prosperity. Those financial records also serve as the basis for the details needed to determine the fair market value of your business in the event of a sale or transfer.

The author has written articles and taught his graduate accounting students his belief that the market place determines the value of goods and services. Given that, we should do accounting to determine if we can provide those goods and services with a favorable contribution to our profitability.

In order for management to make effective decisions, those analyses must be based on timely and accurate financial data. The author's experience has convinced him that the systems in organizations that are necessary to get information to management must also recognize individual preferences for the form and presentation of the facts.

This guide is intended to provide the basic information you need to develop a useful, management-focused information system for your small business.

WHY BROTHER?

To gain a competitive advantage, of course!

Introduction

One long-held myth about financial reporting systems is that they have to conform to the requirements for filing compliance reports. In today's computer-based financial reporting systems that is simply an unrealistic position. The author's Atlanta-based firm, TR-R International, LLC and its Panamá-based franchisee firm, PanUS Accounting & Tax Services, S.A., design financial reporting systems focused on management, not the regulatory agencies. They design the system to do both, but the primary beneficiaries are the management and owners of the closely held business.

The following sections describe the overall objectives of a management-focused information system including the why, what, and how to establish accounts and controls to improve the usefulness and security of your small business data.

First things first

The first surprise is that the key element in a small business information system is neither the software you select nor computer you buy. The single most important element is the people you select and train to keep the records. For some of you, your business is in the startup phase and you are the sole employee. I don't mean to insult you, but you may still need some training to be effective, and not just in the area of accounting or financial management. You must have a personal desire to build an organizational culture that respects privacy and confidentiality and also respects and rewards people who take responsibility for their actions. It starts at the top. Employees are most likely to reflect the priorities of the leadership.

It's what you do, not what you say or write in some obscure policy manual that the staff will emulate.

If you operate in a bilingual environment, then clear communications skills are crucial to the selection process. In Panamá, for example, there are many talented accountants, but a much smaller number of them are bilingual, so be clear in your needs when hiring. It does you no good to have an excellent bookkeeper or accountant if you don't understand each other.

Minimize the risks of failure

The sad reality is that many business failures can be traced back to information failures and the information failures can be traced to poor, or non-existent internal controls. Business people often underestimate the need for good data controls. Many people, new entrepreneurs among them, dislike the notion of 'controls' and 'accountability' and balk at the concept. As a result, they lose track of their goals and don't have objective evidence of whether they're attaining them or not. They don't understand who their best customers are and how much they spend to keep their business, nor how much it cost to find new customers in the first place. They forget what promises they've made for delivery of goods or services. Some even fail to keep control of what they're owed and don't collect from their customers on a timely basis so they have the funds to pay their vendors.

The usual lament is 'I just need more/better customers' but that's a mirage. What they really need is better information to be able to manage their cash flow. The lack of good controls is the 'weak link' in the chain of information processing.

To a novice, these look like typical, small business failures. According to the US Small Business Administration the normal statistic is that one in five businesses started survive five years. Even worse, is the reality that of those that survive five years, only one in five lasts another five.

One goal of this guide is to put you ahead of that curve, to improve your odds of success. One group of folks we hope you never have to deal with are the bankruptcy lawyers and trustees.

Unfortunately good controls are no guarantee that you won't make poor choices; they can't prevent bad decision-making. But effective, management-focused information systems can provide the data to help make better decisions. Effective controls mean better data. Better data leads to better decisions. And better decisions will improve your probability of success.

Two important, distinct kinds of controls are needed.

One set of controls relates to how the data is protected after it is recorded. These controls assure the consistent, reliable recording and categorizing of similar transactions in similar ways. These are accounting controls and they are important. They are the kinds of controls which programmers build into computer systems.

Another set of controls relates to assurances that what actually took place is what is recorded in the records. I differentiate these as operating management controls. They are separate from and precede any internal accounting controls.

If we were sitting face-to-face and I were consulting with you, I would ask you for a tour of the facilities and ask lots of questions about who, what and why things are done in the production of the product or service and how management knows if they're being done properly. You need to ask yourself those questions and consider carefully the answer of how you know if what you expect to happen is actually happening.

In new, startup business environments, often the entrepreneur is the principal employee and intuitively knows if the business is running smoothly. But as the business grows and more staff and support people are involved, the first-hand objective evidence from personally observing what is happening becomes less frequent. It is a natural part of the growth curve of any business. It's a good thing usually to grow. But a problem can arise as a result of the distance 'from the action' of the entrepreneur as he or she becomes more involved in say, marketing, than in production. Controls have to be established to counter the reduction in physical oversight. We call these management controls and they are a simple way to increase the confidence of the owners that everything is happening as it should.

Management science calls this technique 'management by exception' and all it means is that the effort and energy of the leadership is put into those things in need of adjustment. But everything that is important – the successful acquisition of a customer, the management of the sales process, the management of production of the goods or services being sold, and the management of the support efforts - are all elements which can go astray, and therefore are all candidates for operating controls.

We'll go into more detail about operating management controls later. Generally, they are the 'rules-of-thumb', used by every professional in every field to determine if things are going as expected. These 'rules' are the sorts of things entrepreneurs do automatically when they stand at the door to the shop and look out over what's going on. They can see the potential for problems and react to them; make adjustments and corrections. These 'rules of thumb' can be built into the data capture process, and reports can be developed to provide answers when physical, on-site presence is impossible or impractical. This is especially important if your business grows and expands to additional locations.

The basics of effective accounting controls

Effective controls have one thing in common. One element runs through all the jargon, terms, and complicated rules that you will find if you look in any basic, introductory accounting text book. That principle element is the separation of custody from control.

By custody we mean the physical possession of the asset; the cash or the accounts receivable files or the inventory and the related records. Custody also includes the records of what you owe and where the money came from that you use to create and operate your business.

By control we mean responsibility for the verification of the accuracy of the records and the reconciliation of what the records indicate to the real live item those records represent.

A control system must have both elements to operate efficiently and effectively. Without assigning responsibility and verifying the results you may one day discover things are not what they seemed to be. It can be a most unpleasant surprise: one that is easily avoided, along with the equally unpleasant notion of becoming another 'statistic' and failing.

A word of caution is necessary here. Don't merely think that because you use a computer program to do your record keeping that you're fine. There are several very good commercial programs available, which if used properly can provide the kinds of information which is useful for management decision making. The key here is the statement: *if used properly*. This means that the off-the-shelf products need to be set up with the management in mind. The usual preprogrammed categories (what accountants call a 'chart of accounts') are usually based on regulatory filing requirements and still need some modification in order to match the needs of the entrepreneur and his/her decision style, knowledge of their business and it's products, and their desire to track certain key expenses or sales categories which can be effectively used as planning and control information.

Most generic computer accounting systems utilize a functional system of categories. By this I mean the system suggests putting the cost, for example, of mailing things into an account called postage, or some similarly titled category.

The author has a strong preference for using a different sorting process. He feels it is more appropriate to utilize a productivity-activity based sorting system; that means, to follow the postage example, that the cost of mailing or shipping something is put into a category that reflects WHY you incurred the cost, not who you paid. If you were mailing invoices, the cost would be categorized as a collection expense. If you were mailing product or marketing brochures, the cost would be categorized as a selling expense. We'll talk more about this later, but the choice of functional or activity based cost recording is a key difference that impacts greatly the ability to use the information for management purposes.

Get and Use Management-focused information for improved decision making.

The real value of carefully designing and protecting the financial information system data is so you can USE IT to make decisions. This section gets into the basics of why we recommended creating certain categories of accounts.

If your accounting system is designed to comply with regulatory agencies – tax and security regulations, for example -- then you've got a system that's probably easy to audit. That may save you some money in filing compliance reports but are you in business to save money or make money? Sure, you don't want to waste resources, but it's more rewarding to get better margins by selling the more profitable goods and services than to save a few dollars in preparing a tax return.

There's a simple formula to getting better data for decision-making. But it is not such a simple matter to obtain the right data you need to make those decisions.

Contribution margin analyses will provide the answers to which products and services are the more profitable ones. Contribution margins are crucial to making most of the competitive choices businesses face.

The problem with conventional accounting systems is that they don't capture data in a form that's readily available to determine which costs are fixed and which costs are variable. Knowing the difference between fixed and variable costs often means making a profitable decision to provide a good or service versus over-pricing an item and losing a sale; or just as bad a decision, under-price an item and lose money.

The key management decision-making question in establishing pricing is "what will change if choose to do this…" What additional costs will I incur to create this product or service for this customer? What additional revenue will we earn? What other costs will be incurred to get the sale and deliver the product or service to the customer?

The answers are found in the determination of the difference between fixed and variable costs, which are the basic elements of contribution margin analysis. What management really wants to know is which products give the best item-for-item return? Accountants call that return a contribution margin. First it contributes to covering production costs and overhead, then selling and administrative costs, then finally profits.

Some basic definitions are useful here. Fixed costs are costs that do not change with the volume of output and generally don't change over relatively short periods of time. Examples of fixed costs are things like rent, depreciation, supervisory salaries and property taxes. If you are a manufacturer, all of those costs are usually categorized as manufacturing costs and are included in the base cost of a product or a service. If you produce a product the IRS regulations require you to use 'full costing' for valuing inventory, which means that all the direct and indirect costs of getting the raw materials, paying for the labor to convert the raw materials to the finished goods, and the cost of supervising that conversion process are part of the 'cost' of the goods you manufacture and for those products manufactured but not yet sold, they are the costs of the ending inventories (which are also subject in some jurisdictions to property taxes as well).

There is nothing wrong with the principle of full costing for financial statement preparation and the compliance with reporting to various tax authorities. The problem is that information does not help management make decisions about changes in the production process or the sales and marketing of the goods or services. The reason full costing is misleading for these types of decisions, is that some of the 'costs' will be incurred whether you produce a product or not; whether you sell it at one price or at some other price; or whether you sell one product or some other product.

Most business people have been exposed somewhere along the way to the concept of 'break even analyses' – the computation of what it will take to cover the 'nut', that is, how much product or service do I have to sell to cover all my costs. Not to make a profit, mind you; just how much has to be sold so as not to lose money. I am sure no self-respecting entrepreneur goes into business to 'break even' but it's necessary to know how much has to be sold before your can start to earn profits on the efforts and investment of valuable resources to establish your business.

The information you need to know to make accurate break even analyses is to breakdown the cost elements into the portions that are fixed and variable costs. This same breakdown is what should be used to make other decisions about sales and marketing, especially if a customer approaches you and offers to buy a large amount of your product or service but conditions of the offer are based on a 'special price'. There is nothing illegal or immoral about giving different customers different prices, but you may have to be able to justify the pricing difference. Margin analyses provide the tools to do all that.

Hopefully, by this explanation I've convinced you that you need to know the difference between which costs are fixed and which are variable. The question now becomes 'how do I capture that data so I can use it later?' What it means is that the accounting categories used to record the various costs need to reflect this difference. The costs should be broken down at the time they are incurred between which ones are fixed and which ones are variable. Recording them in the accounts can be done with special coding or putting them in separate sub-accounts of the category, for example, production payroll. Part of your payroll is probably fixed, part of it variable, yet all of it is a direct cost of production. Which employees pay doesn't change in relation to production and which employees pay does change with different levels of production? It's not always an easy call, but the easiest time to note the difference is when you first incur the cost not months later when you're trying to go back and analyze it.

Train 'em and trust 'em

Delegate, don't abdicate! Control is a management function which should not be delegated to bookkeepers.

Yes, a good bookkeeper can do the detail work to make the control function faster and easier for the entrepreneur. But the entrepreneur must independently verify the accuracy of the work. And know this: if you abdicate the responsibility for these tasks you better have done a careful job in selection, hiring, and training of the person to whom you have just given 'the keys to the kingdom' – your treasury.

Hire carefully. Talk to a prospective employee's former employers and ask one question: "Would you hire this person again?" There are a variety of government regulations about privacy and most of what you really want to know many employers are prohibited from telling you. I know, it's a frequent outcome of well-intended regulators writing laws that don't work. You can ask and they can answer that one question without violating any government regulations that this author is aware of.

Train your people to develop the kind of attitude and behaviors you want your customers to see. Psychologists and organizational behaviorists call this 'organization culture'. You see it all the time. It's the way people dress, the way they talk to each other, the way they approach their jobs. Again, it's what the staff learns from the top that counts. Be a good role model if you want customer-oriented employees.

Back up your data!

There's a nightmare shared by many small business operators – loosing your client files.

Unfortunately, it actually happened to one entrepreneur in New York. A few years ago thieves broke into a talent agent's office and stole his computer, stereo and video equipment. Along with sweeping the phone system off his desk, the thieves swept the agent's rolodex into a sac and carried it off too. The property was insured. The policy had a small deductible and the business was quickly reimbursed for the cost of the equipment. But it cost the agent nearly a month's wages of three staff people and untold thousands of dollars in lost opportunities to reconstruct the most valuable asset of all – the rolodex file of contracts. Perhaps the ten dollars the rolodex file cost was reimbursed, but none of the staff time to recreate those files was insured. Having your 'rolodex' in a computer file doesn't make it any less exempt from loss. If you're one of the new 'wired' entrepreneurs who keeps all his/her phone contacts in a palm-held device, back them up, often. They can be lost or stolen.

Systems sometimes crash. Your data disk of customers, vendors, employees and your business network contacts is probably your most valuable asset too. Don't leave it lying around carelessly. It is so easy to make a copy and keep it safe. Don't set yourself up to be out of business because you've lost your files!

Use at least two backup copies[2]. The point is to have a set of disks that you rotate for backup. If you have a small number of transactions, then you can backup once a week. If you have large

[2] Three is even better, using the 'grandfather/father/son' concept of backup.

volumes of transactions, maybe you should backup daily. The important thing is to back up the files so that there isn't more than an eight-hour-day's worth of work you must replicate to get your files current if you have some unexpected disaster.

What do you do with the backup copies? Keep one handy in the office safe. If you don't have a safe, then any locking fireproof file cabinet will do. Keep one copy off site in a safe, secure place and I don't mean at your bookkeeper's home or in the car.

On–line? Look out! There are a couple of simple things you can do to protect your proprietary information from on-line viruses, general snooping by curious employees on a network, and intentional, malicious hacking.

Passwords

The first and simplest safety procedure is to use password access controls. Use a combination of alpha and numeric elements in the code. Don't use birthdays, anniversaries or pets names that are easy to remember – they're easy to guess and discover. There's a story I heard about a computer security expert who was being interviewed by an executive. The executive thought his personal access was secure and challenged the consultant to get into the system. The consultant looked around his office, went to his desk and in two minutes had complete access. It seems the executive was a Chicago Cubs baseball fan and there was memorabilia all around the office. The consultant typed "c-u-b-s" and got in without working very hard. Computer thieves are just as smart and observant.

Several good off-the-shelf accounting software packages enable the management to set levels of access so that different staff can use the files they need and not have all the files open to them. Use the file protection systems.

Separate the data storage areas

Another, relatively simple protection is to use a different hard drive for your proprietary information from the hard drive you use for on-line access. The easiest way is to use a different computer, but you can partition a hard drive to 'appear' to be more than one hard drive. This will make it very difficult for someone to hack into the data. It will not prevent a virus from contaminating the drive or save you in the event of a crash. The safest thing if you have only one computer is to use the on-line features with caution and sign off as soon as you've finished retrieving and sending messages. It's unfortunate, but we need to practice the pc equivalent of safe sex when we're on line. If you don't know who the new message is from, then be selective in what you open and who you give access to.

You lock your car don't you?

When you leave your office at the end of the day, put the keyboard in the file cabinet where you lock up your data files. It's impossible to access a system without an input device. If there's no keyboard it's as if the computer is 'out of order'. It's as simple as unplugging a phone to remove and reattach the keyboard. I've never heard of a snoop or a hacker showing up with his/her own data entry device. It's tantamount to leaving your car unlocked and the key over the visor, and you wouldn't do that would you?

Know with whom and where the files are

One last thought from a certifiable skeptic. Be sure you know where all your backup files are and who has a copy. Computer files don't offer the obvious comfort that paper files do, that is: 'if it's here it's mine.' A copy can be made and you won't even know it. A disgruntled employee can in minutes give your hard-earned competitive advantage away to a competitor. Restrict the ability to make copies by setting those options carefully in the control section of your software.

So what now…?

First, congratulations on investing the time to read this brief overview of how your financial data base can be better used and protected. I think if you apply even one or two of these ideas to your business, you will have gotten a good return on your investment.

But what if you want more? What should you do if you recognize that your financial system isn't providing the data in a way that it is useful for your management decision-making style? Or perhaps the safety of your proprietary information isn't what you now realize it should be?

There are several options. One is to ignore it, and hope that your system never crashes, or no disgruntled employee shares your internal business documents with a competitor or worse, some government agency or financial institution comes calling demanding support for the external reports and you know it is there but can't find it.

A better option is to upgrade your data recording system and improve the internal management control systems to protect it, to assure that what is happening is being recorded promptly and accurately, and that the system is providing timely relevant reports that enhance decision making.

Talk to your current accounting services provider. Ask them what they know about management-focused reporting systems and maybe they have someone on staff who can assist you.

Another choice is to contact Dr. Rowley and the team at PanUS to get a free consultation. PanUS has a bilingual Managing Director, Sra M. Guiselle Solano A. She is an experienced management assistant to Costa Rican bankers and investment managers, and a graduate of the ACOBIR real estate course, who oversees a team of bilingual accountants and attorneys licensed to practice in Costa Rica and Panamá. Dr. Rowley is a Certified QuickBooks Pro Advisor and can install, train and support your Intuit products. We also have available for those who become PanUS clients, discounts on purchasing and/or upgrading to various QuickBooks products.

Just send us an email and we'll be happy to meet with you and assess your needs and whether we can help you improve the return on your investment in financial data collection and reporting.

About the author

Dr. Rowley earned his Ph.D. in accounting at The University of Utah where he also earned a Masters in Human Resource Management with an emphasis in organizational behavior. His university research, teaching, and writing were in the area of managerial accounting and measuring the effectiveness of financial management information systems. He earned an MBA from the University of Miami and a Bachelors degree in accounting with a minor in economics from the University of Maryland. He holds CPA certificates in Florida and Georgia.

Tom is an entrepreneur. He founded and managed a regional CPA practice in Miami and owned and operated a Burger King franchise in Salt Lake City. He has consulted with a Georgia-based Fortune 500 company in developing their executive reporting system and developed the strategic plans for the financial information systems at BellSouth Enterprises. From 1999 through 2001 he served as a financial and marketing consultant to an international business center in Costa Rica and other start-up enterprises in Central America. In 2002 he served as financial director of a start-up real estate developer in Panamá, responsible for acquiring properties and assuring subcontractor compliance in the development activities. In 2004 he helped form PanUS Accounting and Tax services as a franchisee of his Atlanta-based LLC.

Dr. Rowley has served on the faculties of Miami-Dade Community College, The University of Utah, and Georgia State University. His extensive education in research and analytical techniques, combined with his sensitivity to the influence of individual and organizational behavior on financial outcomes, provides him with a unique perspective. Those skills are applied to refine existing organizational structures so that the overall effectiveness is improved and the financial reporting systems output is adapted to provide management-focused financial information relevant for assessing the effectiveness of management decisions. Tom also uses that perspective and his knowledge and training in the specific financial and economic models to perform independent business valuation services. Now semi-retired, he coordinates the business reporting and tax needs of exPat investors in Panamá.

While in Atlanta, Tom's community service work included being the Chair of the University of Miami Alumni Association; a volunteer trainer for the Atlanta Business Volunteers for the Arts, and more than a decade as a volunteer construction supervisor for the Atlanta Chapter of Habitat for Humanity. Tom is active in the American Society of Panamá.