Is Your Business Being Hurt By Backward-Looking Bookkeeping?

by Richard Bond in Accounting and Finance

Over the last 25 years I have seen many small- to middle-sized businesses suffer because their financial information is inadequate to properly run their businesses. As these businesses have grown, their accounting function has largely remained stagnant, essentially providing the same reporting and analyses over and over.

If this sounds like your business, then it is probably being hurt by Backward-Looking Bookkeeping. In other words, the finance function is merely providing the bookkeeping which is required for tax purposes, but it is not providing you with the financial tools and information you need in today's ultra-competitive and complicated business environment.

Case in Point: Financial Reporting Problems

Problem: A growing manufacturing company with sales of $30 million had installed a new ERP system, but they were not getting any better or quicker financial reporting. The company was undercapitalized and frequently found itself bumping up against its line of credit, causing the owner significant discomfort and limiting the amount he could invest in new products and programs that would help profitably grow the business.

Situation: The incumbent controller, who had been with the company for 10+ years, had not grown his skills to match the needs of the growing organization. He could not provide the more sophisticated financial analyses necessary to manage the larger and more complicated business the company was now conducting. Management had looked sporadically on several occasions for a new controller, to no avail.

Solution: A confidential search found a new controller who significantly improved the reporting and analysis processes. He was able to close the books in a timely manner. More importantly, the new controller helped reduce inventories by over $1 million, while increasing the on-time order-fill rate from 85% to 90%. The new controller, who has since been promoted to CFO, more than paid for himself, while giving the company better tools to manage the business.

The backward-looking, bookkeeping-oriented controller who was replaced had had the right information and controls. But he had used them merely to guard an asset (inventory), rather than to help his company fully utilize that asset to spur growth, free up capital, and provide a higher level of customer service as measured by on-time order fulfillment.

In contrast, the new, forward-looking controller worked with the management team to help make the business run more efficiently. He was able to use the ERP system to analyze the company's complete financial picture. He brought to the owner's attention two problems: 1. the company had too much overall inventory; 2. they didn't have enough of certain critical items, which reduced company's ability to fulfill its promise of 24-hour-order-turnaround. The team working together solved this problem.

Backward-Looking Bookkeeping vs. Forward-Looking Finance

There is a significant difference between accounting/bookkeeping, which focuses on the past, and financial management, which looks at the future and how management can proactively affect their financial results. If you are like most owners of managers of small- to middle-sized companies, you may be intimidated or frustrated by the accounting aspects of your business.

Owners often complain that it takes a long time to close the books, particularly at yearend, and that they get unpleasant surprises that result in write-offs or other unexpected problems. Backward-looking bookkeeping and a lack of urgency are usually to blame.

As a manager or owner, you need to know your business is doing well and not-so-well. Getting early information about the "not-so-well" will enable you to take timely, corrective action. Any delay in taking that action will cost your firm money and make your profitability problems more serious. Many small to middle-sized companies only produce a complete set of financials on a quarterly basis. Three months into a problem can make it that much bigger.

Fuel Increase Example

Several years ago when gasoline prices spiked, freight carriers increased their rates and/or added surcharges. Owners/Managers who were not aware of this increased cost of doing business found a significant reduction in profitability at the end of the year. Proactive finance people alerted management with the problem and solutions. A good manager would have said, "We either have to add a $10/order surcharge to cover additional freight costs or put through a 1% overall price increase. Otherwise, our profits will be $300,000 less than budgeted for the year."

Key Performance Indicators (KPIs)

A high-caliber financial person gives management KPIs. These key indicators vary by business, but they commonly include: Order Backlog, Inventory Turns, Days Sales Outstanding (DSO), Gross Margin on Sales and Profitability by Key Customers. Staying on top of the KPIs can help identify potential problems early. If your finance or accounting staff are not providing you with KPIs and actionable analyses, you may need to correct the situation. Take your Accounts Receivable (A/R): A forward-looking financial person should be able to quantify where your business stands versus prior quarters, as well as vs. peer-group performance.

Example – Accounts Receivable – A/R

If your business has grown 20% in the last two years, and DSO has remained approximately the same, then A/R would necessarily have grown with the business. However, if your sales declined 20%, and the dollar amount of A/R remained the same, you would have a problem, as your DSO would have risen. If DSO is going up, it means you are taking longer to collect your receivables – a bad thing. If you can reduce DSO, then your A/R person is doing a good job and is freeing up capital. If the controller doesn't know what the company's DSO is, then he is probably not managing the area.

Saying "we run a tight ship" is meaningless without quantification. But if a controller can say, "I reduced DSO from 87 days to 77 days, freeing up X dollars," you have proof positive that he (or she) is doing a good job.

Time for a Change?

If you have backward-looking bookkeeper, then he or she may have to be replaced. Finding good financial people is not easy. You will probably discover that most financial people appear to have "X years of experience," but in reality are closer to having "one year of experience X times." They are likely to keep doing the same things the same old way. And if you replace a backward-looking bookkeeper with someone who is identical in mindset and experience, then you will doom yourself and your firm to repeating history.

However, if you seek out a forward-looking financial person who can demonstrate that they have quantified accomplishments, then that new hire will more than pay for themselves.

Richard Bond is owner of Bond and Company. Over the last 25 years he has developed a process called Results-Based-Recruiting, which helps companies find proactive finance people who are part of the solution rather than part of the problem. Mr. Bond has an MBA in finance from the Wharton School and has also owned and run a family business and worked in finance in Fortune 100 companies. Learn more about his approach to small business finance recruiting at www.bondandcompany.com.

Email address:
Richard.bond@bondandcompany.org

Website:
www.bondandcompany.com

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