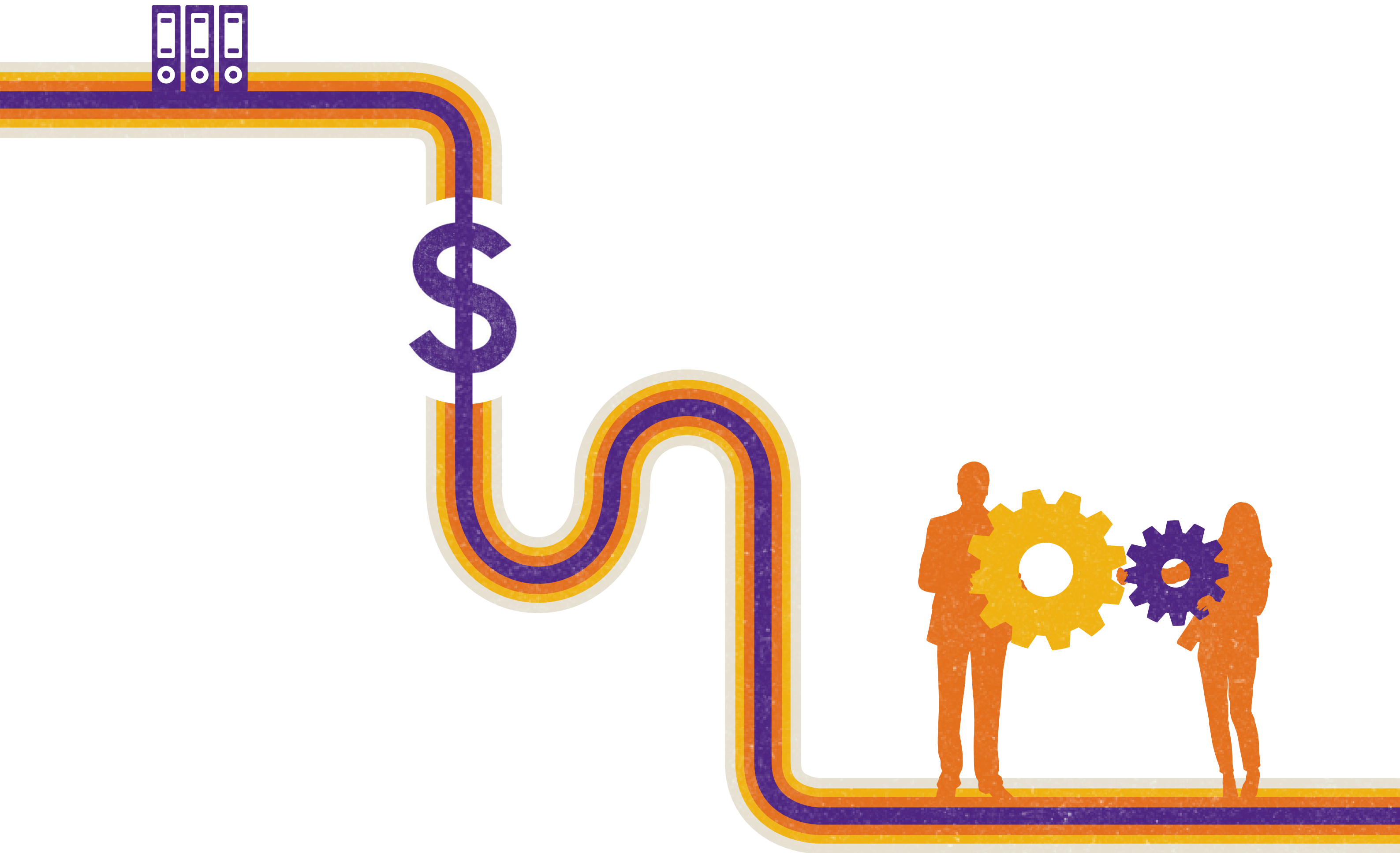
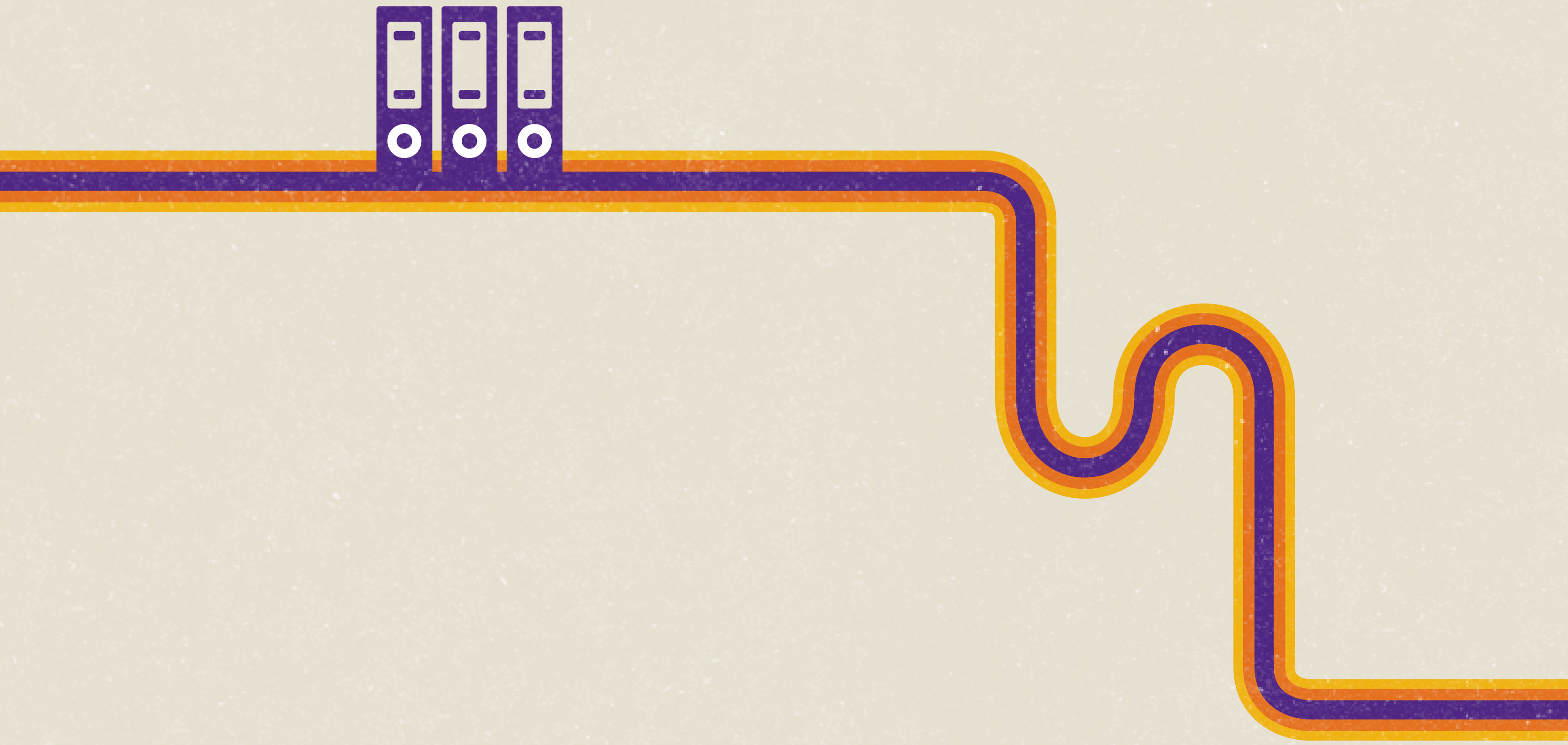
Grant Thornton

An instinct for growth™

The hidden price of reducing compliance costs





About us

Grant Thornton is one of the world's leading organisations of independent assurance, tax and advisory firms. These firms help dynamic organisations unlock their potential for growth by providing meaningful, forward looking advice. Proactive teams, led by approachable partners in these firms, use insights, experience and instinct to understand complex issues for privately owned, publicly listed and public sector clients and help them to find solutions. More than 38,500 Grant Thornton people, in over 130 countries, are focused on making a difference to clients, colleagues and the communities in which we live and work.

1 April 2014 was a day of celebration for many small to medium sized business (SME) owners. That's when the Financial Reporting Bill and the Financial Reporting (Amendments to Other Enactments) Bill came into force, removing the requirement for an estimated 98 per cent of New Zealand businesses to prepare general purpose financial statements.

Think of the cost savings. Think of the reduced administration, and the end of that post-March panic as administrative staff gather up all the records demanded by the external accountant.

Indeed, that's largely the intent of the new Act – to reduce compliance costs for SMEs. And that, surely, is a good thing.

Actually, for many businesses it will not be.

Even without the legislative demand to prepare general purpose financial statements, there are still many powerful reasons to continue to prepare them to a standard close to what has been prepared in the past – if for no other reason than to comply with the Income Tax Administrations Act 1994. On top of this, almost every business, regardless of size, will be better off in the long run if they produce and interpret regular financial reports, as these help a business run more effectively.

Here are five reasons why.

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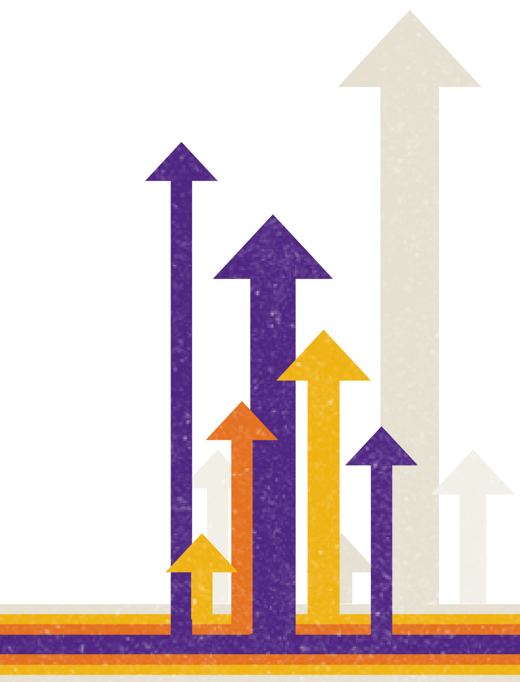
❶ It's not just about compliance

Financial statements are far more than a compliance issue. They're one of the most critical tools available for ensuring financial performance supports the long term survival and success of the business.



These benefits are well understood by large corporates – and the time is right for owners of all businesses to understand them. The bottom line is this: not preparing annual financial statements is likely to cost more in the long term than the moderate, short term savings made by not preparing them. Consider this [2001 statement] from the independent US Financial Accounting Standards Board (in relation to voluntary disclosure):

"Investors benefit from the reduced likelihood that they will misallocate their capital. Companies (and their owners) benefit from:

- a lower average cost of capital
- enhanced credibility and improved investor relations
- access to more liquid markets with narrower price changes between transactions
- the likelihood that they will make better investment decisions (as users of other companies' financial statements)
- lesser danger of litigation alleging inadequate informative disclosure and better defenses when such suits are brought".

It should be clear by now how that happens. Financial statements allow business owners to:

- see the role cash plays in every business decision
- understand whether the business is running at a profit or a loss
- calculate funds needed now and in the future to ensure short term positive cash flow and medium to long term growth.

For lending purposes, financial statements help owners to:

- judge their ability to repay loans
- assess whether lending is justified and if so, how much and over what term
- decide whether to buy or lease assets, and if buying, whether to seek financing for them
- assess what collateral is available to secure a loan.

For these reasons, we encourage all business owners to judge carefully for themselves whether there is any long term advantage in avoiding the short term cost of preparing a well-considered set of financial statements. In our view, the answer in all cases will be that there is no advantage.

2 Lending

[In 2012, US banks rejected more than half of all small-business loan applications](). Yes, the economic environment at the time was especially tough, but if a business can't borrow in tough times, its chances of long term survival are slim.

Banks and other lenders insist on understanding borrowers' financial positions. The pitfall for a small business owner is assuming that access to their bank statements tells the bank all it needs to know.

In fact, much of the critical information that determines the creditworthiness of a business is not available from bank statements. For example, one figure a lender uses is the "cash coverage ratio", calculated by taking net income and adding back depreciation, which is not a cash expense (that is, depreciation does not show up on bank statements).

This ratio provides an indication of net cash flow – the lifeblood of every business. If a lender can't measure cash flow, they can't lend with confidence.

What's more, many small business owners enjoy secondary sources of cash flow, such as their spouse's income or wages from a part time job. If that income is paid into a separate bank account, it will be invisible to the primary bank – unless of course it is shown on a financial statement.

Financial statements also indicate:

- the debt to equity ratio - the value of the business's assets divided by total liabilities, and another key factor in the bank's decision making
- the tangible assets that can be liquidated to pay off the loan. Assets include accounts receivable, inventory, furniture and equipment, real estate (business or personal), and cash investments or cash on hand. Different assets are valued differently by the bank for lending purposes – for example, furniture is worth much less than cash on hand because it is less liquid and depreciates rapidly

Not only do good quality financial statements improve the chances of securing a loan, they can also help secure more favourable terms. A 2011 study published in the Journal of Accounting Research found that companies with audited financial statements enjoyed interest rates nearly three-quarters of a percent lower than companies without. On a loan of $500,000 over a 10 year term, that's a difference of $23,000 in interest.

Quality financial statements can improve the chances of securing a loan and help secure more favourable terms

3 Business planning

Many business owners assume that because financial statements are a record of what's happened, they are of limited use when looking ahead.

But that logic is fundamentally flawed.

Financial statements are more like a snapshot in time than a view of history. While they certainly track and report activity over (usually) a 12-month period, a great deal of their value is in measuring the state of the business right now.

Even historical data helps in this, as a quick glance at the three main components of a financial statement will show.

i Income statement

The income statement summarises revenue (mainly sales) and expenses. The bottom line of the income statement shows net income. Net income, in turn, shows whether the business is profitable or not – right now.

That may seem counter-intuitive; after all, what if the business was unprofitable for the first seven months of the year but made a profit in the last five months? Surely, then, that means it's profitable now, even though the income statement may suggest otherwise.

While that's a valid point, it's also the exception that proves the rule. Profitability is never a function of what's happening at a particular moment, but is measured over time. In other words, to understand if a business is profitable right now, you must look at what's been happening over a selected period up to this point. Yes, the data is historical. But equally, it's only historical data that allows you to assess the state of the business – in profit or loss terms – right now.

ii Balance sheet

The balance sheet is, literally, a snapshot in time. It lists a business's assets and liabilities on a given date, comparing what the business owes against what it owns.

Unlike the income statement, the balance sheet can change radically in a short time; for example, by a business selling or buying a major asset.

Like the income statement, however, the balance sheet is a powerful indicator of business health. As every business owner should know, cash is critical – and the balance sheet allows owners to calculate how many days of working capital they have available, which in turn measures the business's ability to pay its bills during typical fluctuations in revenue.

Failure to understand this metric can lead even a profitable business to insolvency if it has a period of loss without a sufficient cash cushion. In the worst-case scenario, it can also lead to directors of the business facing litigation, or civil or criminal charges based on demonstrable mismanagement.

As a general rule of thumb, a business should have at least 60 days of working capital. A strong balance sheet (business) will typically have 120 days or more.

Not only is the balance sheet a powerful snapshot, but successive balance sheets can help identify important trends, such as growth in the average time between invoicing and receiving payment (called the receivables cycle). When a business identifies such trends, they can act to rectify them by taking actions such as collecting payments more aggressively or ridding itself of laggardly clients that are damaging cash flow.

The balance sheet also reveals what proportion of net profit is being retained in the business for future growth, as opposed to funds withdrawn by the owners.

Smart business owners keep a close eye on their balance sheet, reviewing it more often than once a year. For them, it's a critical part of their company health check that they wouldn't dream of doing without.

iii Cash flow statement

If you think cash is king for a business, you're right. And the power behind the throne is the cash flow statement.

This statement shows how much money has come into and gone out of the business over a given period, and how much will be kept on hand to cover emergencies. Keeping the statement current and valid forces the business to make sound predictions about future sales and purchases – and, as far as possible, meet or exceed the former while staying within the latter. So how does a cash flow forecast relate to the historical component of financial statements? Put simply, a realistic forecast will always be guided by past performance (note we said "guided", not "constrained"). Of course, if the owners have ambitious growth plans, this year's cash flow forecast should look different from the previous 12 months. But even then, the difference will be relative – if the company is aiming for 20 per cent growth, the last 12 months of cash flow should be used as a starting point (otherwise, the question arises, "20 percent growth compared to what?").

On that note, businesses in growth mode can be even more susceptible to cash flow challenges than companies that have plateaued. They typically need extra working capital to fund the extra equipment they need to buy, or people they need to hire. One of the most common and saddest causes of business failure is profitable companies running out of cash as a result of poor (or missing) cash flow planning.

Cash flow statements are also critical if a business plans to borrow, as they not only help demonstrate good financial management, they also provide a powerful reality check for the company's business model. If the model doesn't generate adequate cash flow, it will not produce a successful business. Many a shrewd business person has chosen not to pursue a tempting business path after doing the hard graft of cash flow analysis. Yes, the model may have ultimately proved profitable. But cash flow analysis will reveal whether the business has a reasonable chance of surviving the ups and downs that will occur between now and that happy time when cash flow is both steady and positive.

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4 Inland Revenue

For those companies affected by the changes to the Companies Act, only the obligation to prepare general purpose financial statements is removed. Companies will still be required to prepare financial statements to a minimum level prescribed by Inland Revenue.

These financial statements should:

- be based on double entry cost-based accrual accounting
- include a balance sheet and profit and loss, along with supporting notes and/or schedules
- use tax values where possible to determine income and expenditure, and in preparing the balance sheet
- include a statement of accounting policies and changes
- include, if necessary, financial statements to taxable income reconciliation.

It is a relatively short step from meeting these Inland Revenue requirements to generating general purpose financial statements – which means the cost savings in not preparing general purpose financial statements will be limited.

Of course there's a more serious possibility to consider. If a business is audited by Inland Revenue, a lack of good quality financial data may well work against it, and will certainly make it difficult to challenge any assumptions Inland Revenue makes about its financial affairs. As a rule, businesses should always assume that where conclusive information is missing, Inland Revenue will assume the worst (from the business's point of view). To that extent, financial statements – along with sound record keeping – can be viewed as an effective (and highly cost effective), inoculant against unfavourable decision-making from Inland Revenue.

5 Preventing and detecting fraud

Sound financial analysis can pick up aberrations that indicate fraud. Ironically, preparing financial statements not only helps detect such behaviour, it also reduces its likelihood. The reason is simple: when employees know the company is well managed, they are less likely to be tempted to steal.

A common misconception is that only larger companies suffer from fraud. This is far from the whole story. According to the Association of Fraud Examiners, occupational frauds within small businesses result in greater losses than those experienced by larger organisations. In fact, they put the average fraud for small businesses at $190,000. Could your business withstand such a loss?

Some closing remarks on the limitations of financial statements

Financial statements are critical but they have limits. One pitfall awaiting conscientious business owners is becoming entranced by their financial statements, and spending far too much time on them. For most privately owned businesses, preparing financial statements including cash flow forecasts should be a monthly exercise. That way you can only be wrong for a month!

The following are the day-to-day issues most likely to impact all but the biggest business.

Cash on hand (or in the bank)

Always know what the company bank balance is and how much debtors owe. Do a monthly reconciliation and keep an eye out for irregular or suspicious items showing up on the "out" column.

What's owed to the business and what the business owes

Keep a close eye on unpaid receivables and payables. This will tell you a lot about how the business is doing. Keep an especially close eye on aged receivables – the slow payers – and do everything you can to change their ways or, if they won't, replace them with clients who pay on time.

Backlog

Does your business have work orders that have been received but not yet acted on? If their number is growing, that's a red flag of looming problems – unhappy customers followed by a downturn in business.

Pipeline

Do you have a secure channel for generating new business? Is the pipeline full, half full or a mere trickle? When there's plenty of work on, it's easy to forget the need to keep the pipeline full, and the result can often be disastrous – a sudden halt to work followed by layoffs, for example.

Every business in New Zealand is unique and its financial statements should reflect this and be used to assist in key decision making processes.

average fraud for small businesses: **$190,000**

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