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The importance of bridging the GAAP

Brad Cherniak, Financial Post · Aug. 9, 2011 | **Last Updated: Aug. 9, 2011 5:12 AM ET**

'Ancient history," "irrelevant," "expensive," "only do them for the bank," "really not sure why I do them." Those are just a few of the comments entrepreneurs and business owners often make about formal audited or accountant-reviewed financial statements.

Are they right? No, but like financial models, which I wrote about in my previous column, financial statements are also tools often misunderstood by business owners.

What are GAAP (Generally Accepted Accounting Principles, which is the established methodology) financial statements not good for?

Day-to-day operations: GAAP prepared statements are not timely enough for this. You need to operate your business with live data. Depending on the size and stage of your business and its complexity, you may need to make decisions on daily sales and costing data and cash flows. Quarterly or even monthly interim statements are not granular enough.

Figuring out where you make money: However, they are a good starting point. Companies should dig further into their reported revenue and gross profit to figure out which clients are actually profitable and whether they are becoming more or less so over time. They also need to look not just at the direct materials and labour used (in Cost of Goods Sold), but how much of the company's total corporate and overhead resources and staff time and attention are tied up serving these customers. This process is more art than science, and will involve some estimation, but is critical for growing companies.

Managing cash: See the previous two points.

On the other side of the balance sheet, GAAP prepared statements are good for the following:

An invaluable periodic sanity check: They offer the chance to compare your financial results and operating metrics with similar companies; in particular, publicly listed companies for which there is often ample financial information. This comparison should be done regularly. Not only to act as an independent check on how you are running your business and what you may be able to do better, but also to monitor changes in your industry and act as a tripwire for emerging trends.

Third-party validation: This is still the most important use of financial statements, particularly for business owners who plan to raise capital or sell their businesses. Having at least two or three years of audited statements by a known and reputable accounting firm can also help business owners show evidence of good governance practices, which can bolster the value of the company. It may also increase the interest of foreign buyers, who often rely on these statements more than local buyers.

Best way to learn about your balance sheet: Entrepreneurs will often ignore their balance sheet and focus solely on their income statement. Indeed, they will often focus solely on sales and assume if they are growing everything else will be fine - a dangerous assumption. All formal GAAP prepared statements include a balance sheet, and entrepreneurs should be forced to look at it and learn how it changes, and why this matters. This can lead to better cash-management and strategic decisions and reduce the risk profile of the company. The balance sheet tells you whether that something is worth doing, in part through the cash balance. It's not useful for managing cash day-to-day, but it shows you periodically and objectively how this most key of numbers is changing.

Provide an unchanging and objective, if imperfect, standard: Well, at least they used to do that. It has been mandated in Canada (but not yet in the United States) that all businesses move this year from the current longstanding Canadian GAAP standard of financial statements to either International Financial

Reporting Standards (IFRS) or a variant of Canadian GAAP. IFRS is generally targeted to larger, public companies, and is intended to be less rigid and rules-based and more intuitive than GAAP. The second option is largely targeted to SMBs and is intended to be less onerous and disruptive than IFRS, and perhaps even GAAP.

Ignoring the issue of which of these is better, I believe multiple new standards are coming at a bad time for small businesses, reducing the comparability of existing financial statements and increasing general uncertainty, even if only temporarily. Money will also have to be spent on staff training, systems and programming.

The bottom line is formal financial statements should be more than a package of documents you get from your accountant every quarter and file in a drawer.

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