Growth Rock News

January 2009

A manager's guide to build durable businesses on rock solid controls

Contents

Reconciliation Workpapers - Why Do Them?

Workpapers are the by-products of CPA firms. Auditors and tax accountants produce workpapers to support information that is filed with the Security and Exchange Commission, Internal Revenue Service or other government agencies. Due to the importance of the information, workpapers help protect against lawsuits and make work more efficient and accurate.

Workpapers, however, should not be the domain of only auditors and tax accountants. Corporate accountants should also use workpapers to support important financial information produced internally, such as monthly financial statements and annual financial budgets. For year-end financial statements, workpapers are indispensable.

Workpapers should be used as part of the monthly close when accounts are reconciled. They provide documentation of how amounts are derived to check the accuracy of financial statements.

Many small, privately held companies do not prepare reconciliation workpapers. Many such companies are on a cash-basis and do not close their books each month. Management assumes that their accounting system is correct and can be relied upon.

A cash-basis company may close the books once a year to do its tax returns. For companies that close their books each month, many do not prepare comprehensive reconciliation workpapers. Many prepare only bank account reconciliations.

For example, a company's workpapers consist of a bank reconciliation pulled from QuickBooks. The report is stapled to a bank statement and then filed somewhere in a file cabinet. Workpapers require more rigor and structure to be of value to the company.

Why do them?

Speaking of value, why do companies have workpapers? The use of workpapers can be illustrated by the Grimm's fable, Hansel and Gretel. Poor little Hansel and Gretel were lost in the forbidding forest. To help find their way back home, Hansel scattered pebbles and pieces of bread along the woods as a path marker. Similarly workpapers help accountants trace a path back home to the financial statements.

Specifically workpapers have the following benefits:

1) Protect against litigation - As with auditors and tax accountants, workpapers are prime CYA documentation. For corporate accountants, workpapers may save a person's job. In case a CEO or CFO has a question, the accountant is covered because there is documentation to support a balance.

If a company has to issue year-end financial statements to the SEC, workpapers may protect the company as a whole and individually from shareholder and creditor lawsuits. Corporate accountants would do well to protect themselves and their bosses

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The Daily Cash Report

Cash reporting is an area that many companies want to have a better handle on. Fast growing companies in particular need better cash reporting, because they usually have a lot of cash tied up in working capital and fixed assets. Relying on a month-end cash balance is not enough, because cash balances can fluctuate significantly from week to week. Often management needs to answer the simplest of questions, "Do I have enough money for this week's payroll?"

Cash reporting would be easy if there was not a difference between the bank and book balance or if there were few transactions. The company can find out the cash balance by calling the bank or accessing the information online. Alternatively, the company can use the general ledger. Unfortunately, it's usually not so simple. At any point in time, the bank and book balances are seldom the same; in fact, the two balances may not equal the true cash balance. There are usually timing differences and reconciling items, such as outstanding checks, held checks, deposits in transits and ACH / wire transactions.

Why is it necessary to know the correct cash balance? Isn't relying on the bank or book balance enough? It would not be an issue if a company has few cash transactions. Unfortunately fast growing companies turn cash quickly. There are more sales and disbursements transactions. For example, retail companies may experience a sharp increase in daily cash and credit card sales. Manufacturing companies undergoing major capital expansion may issue checks frequently for labor, materials and capital equipment for various projects.

The cash balance can have major swings. Some companies survive week to week, assessing their cash collections before deciding whether to pay bills. In extreme cases, companies are watching the cash float, because they have negative cash. These companies may be watching every check issued to see whether it has cleared before issuing new checks. For an upstart company, it can be embarrassing and damaging to receive a call from a vendor saying that a check bounced. When this happens, the company's credit and credibility can go out the window.

Besides being able to pay bills, knowing the correct cash balance is important for other reasons:

1. Improve controls. Doing a cash report forces managers to continually monitor what is going on with their most important financial asset. When it's done daily, the manager can detect unusual or unauthorized transactions, including employee theft, unauthorized ACH debits from third parties and bank errors. For companies that receive or send frequent wire or ACH payments, it's important to verify amounts that actually cleared the bank. When problems arise, it's better to follow up right away with the bank instead of waiting until the end of the month when the account is reconciled. Also, by monitoring the cash balance daily, finance managers will be inclined to record bank transactions daily to keep their books up to date. Recording bank transactions daily will make reconciling the bank account at month-end easier and will help speed up the month-end close.

> "To manage cash flow, you first have to know your cash balance."

2. Improve cash flow. Monitoring cash is essential to improve cash flow. If done correctly, cash reporting improves working capital management. Fast growing companies experience frequent changes in their working capital accounts. Managers are challenged to stay on top of accounts receivables, inventory and payables - three key levers that control operating cash flow. If the manager determines that cash collections in a given week are low, he / she can warn purchasing that they should slow down inventory purchases. Further, accounting can improve payables management by knowing how to schedule payments to vendors. Sometimes payments can be delayed without risk of damaging the company's trade credit. It's important to have the right information to determine the amount of cash tied up in working capital. To manage cash flow, you first have to know your cash balance.

3. Maintain liquidity. Fast growing companies tend to finance growth through debt. Liquidity is the ability to meet financial obligations when they become due. Companies may have not only debts to trade vendors, but also debts to banks, private lenders and other creditors. Having a cash report that provides a forecast of the scheduled principal or interest payments will help managers maintain sufficient liquidity. If there

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Reconciliation Workpapers...

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from financial loss and in extreme cases jail time. As illustrated by investor lawsuits in recent years, when the stock price plummets, everyone in the company is a potential target from the CEO and CFO all the way down to the office janitor. Fraud litigation will not get better in the near future with huge losses suffered by investors in 2008.

> "Workpapers may not save a company from lawsuits but can speak in spades about the accountant's due diligence or lack thereof."

Given the current environment, companies should protect themselves. Workpapers may not save a company from lawsuits but can speak in spades about the accountants' due diligence or lack thereof.

2. Help speed up the monthly close. If accounts are reconciled monthly, workpapers serve as "cheat sheets" to speed along the reconciliation and close process. For companies with traditionally time-consuming and complex accounts, such as inventory, accrued expenses, debt or equity, having workpapers is indispensable. Accountants can refer to schedules in the previous month to gain a concise view of any change and update for current activity.

3. Make auditors' job easier. Audits go much more smoothly and quickly if there are good workpapers. Think of the frequent interruptions and time spent when auditors have to ask questions because a particular schedule is missing, incorrect or unclear. Audit efficiencies gained from having well documented workpapers can be substantial. Time saved translates into money saved, especially when auditors can bill out as much as $300 to $400 per hour.

4. Help managers "get under a number." Being able to explain changes in account balances is important to understand what is happening in the business and serves as a check. If something does not appear right, the workpapers will speak loud and clear. Also, accountants can act as value added business partners when they have a thorough understanding of what is happening in the financial statements.

5. Facilitate internal audit reviews. Workpapers provide a way for senior management to monitor internal controls year round. Workpapers are fertile grounds to find cancerous problems that can wreck the integrity of a company's financial reporting.

Elements of Workpapers

What makes up workpapers? There are various elements of workpaper documentation. The following sets forth the elements and provides an example of what typically goes into workpapers as part of the month-end close. The example should be used as a guide.

Workpaper documentation goes beyond financial schedules. It includes not only financial schedules and supporting documentation, but also the system of cross-referencing among schedules. Referencing is a way to check the accuracy of the financial statements by tying the summary data to the detailed schedules. A referencing system should include workpaper indexing and tickmarks.

The next section provides an outline and brief description of each workpaper element.

1. Schedules
   a. Financial statements - include the balance sheet, income statement, cash flow statement, supplemental reports and variance explanations.
   b. Adjusted trial balances & adjustments - include the adjusted trial balance, top-level adjustments and intercompany eliminations.
   c. Lead schedules - are summary schedules that support a financial statement reporting line, such as cash, accounts receivable, inventory and fixed assets. Lead schedules list individual accounts comprising the summary total on the financial statement.
   d. Supporting schedules - provide detailed information that supports the lead schedule
      i. Manual schedules
      ii. System reports - subledger reports (subledger aging, G/L detail reports, transaction reports)
2. Workpaper indexing - a systematic page numbering system
3. Tickmarks - symbols used to reference amounts between schedules and amounts to external sources
4. Workpaper tabs - divider tabs to separate sections in a binder

Please refer to the February issue for a continuation of this article. The February issue addresses workpaper indexing, tickmark referencing and other valuable tips.

—GRN 01/09

The Daily Cash Report

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is risk that the company will not be able to meet vendor and creditor obligations, management can take action accordingly.

4. Optimize treasury function. As a company grows, the treasury function becomes increasingly important. Cash reporting is a catalyst for all treasury activities. Knowing accurately how much cash is on hand will help managers decide the optimal cash balance to maintain. During periods when there is excess or idle cash, the company can re-invest or re-deploy cash to earn higher returns.

Some companies have a treasury policy whereby subsidiary companies transfer excess cash to the parent company. The parent company decides how best to allocate the cash. The parent company can transfer funds to the subsidiary company with cash shortfalls or invest residual cash in higher interest-bearing money market instruments.

Effective treasury management requires keeping a minimum cash balance at the subsidiary company. Doing so not only helps to increase returns but also to improve controls. With a lower cash balance, management at the subsidiary company is less tempted to spend on things they don't need. And there is a lesser risk that cash goes missing.

Why Do It Daily?

A rule of thumb is that either the cash report is done daily or it should not be done at all. If the report is done less frequently, such as weekly, the accountant will need to update a week's worth of transactions, which takes more time and increases the chance for errors.

Preparing the cash report should be a part of the accountant's daily routine, like opening mail. If done daily, the report should take no more than 30 minutes to an hour to do. This is time well spent; the accountant will know exactly what the cash balance is each day. Also, even though the cash report may be done daily, it can be distributed to management less frequently, such as weekly.

What Should be Included in a Cash Report?

A good cash report should include also working capital accounts, such as marketable securities, accounts receivables, inventory and accounts payable. These additional accounts help management assess liquidity. Liquidity is a prime concern for fast growing companies, because they typically carry substantial debts.

The cash report should also provide a forecast of receipts and disbursements. Having a forecast of receipts and disbursements will give managers a better grasp of potential liquidity problems. This information will help them better plan inventory purchases, schedule vendor payments or seek alternative short-term financing to bridge a cash shortfall.

The daily cash report is a valuable and versatile tool. It strengthens controls, improves cash flow and helps maintain liquidity. When done faithfully, the cash report is a beacon that illuminates a company's growth path and keeps management on a steady course.

—GRN 01/09

Format of a Cash Report

Total receipts
+ cash and credit card sales
+ receivables collections
+ other
Less: total disbursements
- accounts payable
- payroll
- other
Net cash increase / decrease
Beginning cash
Ending cash
Add / subtract: working capital
+ marketable securities
+ accounts receivable
+ inventory
- accounts payable
- accrued expenses
Net working capital

Controlling Consulting Costs

Top 10 Ways to Keep Accounting Software Training and Support Costs Under Control

- By Kate Spontak

It's important for employees to understand how to use the accounting software, particularly if a company recently installed a new system. Learning to use the new system correctly at the onset can avoid costly errors and problems down the road. Companies that make a significant investment in hardware and software should also invest in onsite training and consulting time for their staff. Providing ongoing professional training to staff is a sure way to help them become proficient with the system. To keep consulting costs under control, companies should keep the following points in mind.

1. Try to have employees become familiar first with the program by using help screens and manuals and checking written procedures. Doing so will allow consultants to help employees become self-sufficient more quickly. The goal is to help them generate better reports, provide more efficient customer service or enhance the use of the software.

2. Have clear goals about what you want to accomplish from a consulting engagement. Consultants can propose a better solution when they know your ultimate goal. A few hours spent in a planning discussion can save many hours of re-work. Having a written agenda for the day will keep the discussions focused.

3. Let consultants know how much a solution is worth to you. Whether two hours spent creating a report saves you ten employee hours a week, or half an hour every six months depends on your particular business. Prioritize your requests. Consultants try to make their time valuable to you, so that you can do more in less time.

4. Use the consultants' time wisely. Although consultants love hearing about you, your family and your last vacation, please keep small talk to a minimum, so that they can focus on your business. Fit in questions or conversations when a process requires waiting time.

5. Make sure everyone in the office knows when consultants will be working on the accounting system and when users will have to stay out of the system. Plan other work for the accounting staff during this period.

6. Plan for undivided attention during training sessions. Telephone calls, lunch breaks and vacation days should be rescheduled during training. Consultants can be flexible in scheduling, but they can't train someone who isn't there, or isn't focused on the training.

7. Keep a file folder of questions that come up between visits. Put in a sample of the report or transaction that brought up the question. You may not remember the whole situation when the consultants last talk about it unless you save a reference.

8. When a question needs to be addressed between visits, print the relevant documents and send them by fax along with your question. Or attach a file to an e-mail message. Seeing the documentation helps consultants understand your question.

9. If you need an immediate answer, have your documentation available and be ready at the computer to walk through the solution.

10. If you have to leave the consultant a message, be sure to include your phone number and extension, and tell him / her when the best time to call. A consultant may not remember that you take lunch at 12:30 p.m., or that you leave at 3 p.m. on Wednesdays.

—GRN 01/09

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IN THE NEWS...

Pilgrim's Pride Files for Chapter 11

Pilgrim's Pride, the nation's largest poultry producer filed for Chapter 11 bankruptcy protection in December 2008. Under Chapter 11, the company will continue to operate while it restructures its finances to meet creditor obligations. Based in Pittsburg, Texas, the company has over 49,000 employees and has operations in the US and Mexico.

According to financial statements filed with the Security and Exchange Commission, the company earned $47.0 million on revenues of $7.6 billion for the fiscal year ended 9/30/07. The company had problems in 2008, as a result of falling poultry prices, higher feed costs and higher debt levels. The company's debt increased 237% to $1.3 billion as of 9/30/07 after the company acquired Gold Kist, Inc. in January 2007. As with other poultry producers, Pilgrim's Pride operates with a low profit margin and low return on assets.

According to *Forbes*, Pilgrim's Pride announced that it would report a $802 million loss for the fourth quarter ended September 2008. The company's liquidity had been tenuous after its $1.1 billion acquisition of Gold Kist in 2007. The net profit margin for fiscal year 2007 remained negligible at 0.65%. Asset turnover declined to 2.01 times versus 2.16 times in fiscal 2006.

The company's Y/Y revenue growth rate of 45% was 10 times its sustainable growth rate of 4%. The growth was fueled by an increase in debt used to finance the Gold Kist purchase. The high debt levels, an aggressive growth rate, higher feed costs and falling prices were factors that led to the liquidity crisis and Chapter 11 bankruptcy filing.

The fate suffered by Pilgrim's Pride is a lesson about growing too quickly with too much debt. Having a low asset turnover and high debts is a big liquidity red flag. Companies with a low profit margin or low asset turnover ratio would do well to grow carefully with manageable levels of debt. A good benchmark is to compare the compay's actual growth rate with its sustainable growth rate (SGR). SGR is the rate at which the company can grow organically without needing external capital. SGR is an important topic that deserves a special discussion in a separate article.

—GRN 01/09

Financial Ratios - Days Sales Inventory

Companies that sell product inventory should consider tracking days sales inventory. Days sales inventory (DSI) is a working capital measure to assess how effectively the company manages inventory. Specifically it measures how long the company takes to sell or turn inventory. In other words, DSI tells how many days of cash is tied up in inventory. Healthy companies with strong cash flows are able to turn inventory quickly and have a low DSI. Conversely weaker companies will carry high inventories and have a higher DSI. If left ignored, a growing DSI will create cash flow problems and result in excess and obsolete inventory that will need to be written-off.

DSI and the inventory turnover rate are calculated as follows:

DSI (days) = avg inventory / COGS per day
Inventory turnover (times) = 365 / DSI

DSI is best used when tracked over a period to identify a trend and also to benchmark against comparable companies within the same industry. Companies should try to keep DSI moving downward. A deterioration in DSI will require management to review inventory stock and identify slow moving inventory. A build up of slow moving inventory is a sign of poor purchasing and merchandising.

Successful companies understand the importance of effectively managing inventory levels. Industry leaders, such as Wal-mart, SYSCO and Dell, consistently rank among the best companies in having a low DSI and high inventory turnover. Not surprisingly, they are among the most profitable companies within their industry.

DSI helps managers monitor inventory movement and improve purchasing decisions. Keeping excessive inventory ties up cash and increases operating costs. Companies often forget that in addition to inventory purchase costs, there are also labor/handling, storage and other overhead costs. DSI can help companies keep minimal inventory to increase cash flow and profitability.

—GRN 01/09

Sudoku

2			3				4	1
	9			1				
5	1				8		6	
4		6		7	2			
			5	6		7		4
	5		8				9	6
				3			8	
9	7				4			3

www.sudoku-puzzles.net

Sudoku puzzle is printed with permission of www.sudoku-puzzles.net.

Sudoku Instructions:

The aim of the puzzle is to enter a number from 1 through 9 in each cell of a grid, most frequently a 9×9 grid made up of 3×3 subgrids (called "regions"), starting with various numerals given in some cells (the "givens"). Each row, column and region must contain only one instance of each number. The solution to the puzzle can be found at the URL link, www.anthillworks.com/resources/sudoku.html.

Quips & Quotes

“Never call an accountant a credit to his profession; a good accountant is a debit to his profession.”

- Sir Charles Lyell (American accountant 1797-1875)

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Growth Rock News is a monthly newsletter published by Anthill, a consulting firm that helps fast growing companies execute on growth strategies. Anthill works with companies to reduce risks associated with rapid growth by building controls to improve profitability, cash flow and business credit.

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Accounting Calendar
January 2009

January Reminders

1. Send 2008 W2's and 1099's to employees and independent contractors by 2/2/09.
2. Deposit 2008 FUTA taxes if <= $500 by 2/2/09.
3. File 2008 Form 940, Form 941, Form 943, or Form 944 if you did not deposit all taxes when due.

Sunday	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
				1 New Year's Day	2	3
4	5	6	7	8	9	10
11	12 Deadline to report employee tips of $20 or more for Dec	13	14	15 Individuals: final installment 2008 estimated taxes due	16	17
18	19 Martin Luther King Jr's Birthday	20	21	22	23	24
25	26	27	28	29	30	31

Source: Internal Revenue Service. (2008). 2009 Tax Calendar for Small Businesses and Self-Employed.