Dressing up your financial statements

When you must prepare financial statements for someone's eyes other than your own, first read them and see if they are telling the story you want.

by Dan Saunier

You, as a businessman, on occasion may have to provide financial information to outside parties. Generally speaking, you will only do this when you have no choice (i.e., the government) or when you want something.

In the case of government reporting, we suggest the minimum. Give them what they can legally ask for and ignore the rest. Too much information is worse than too little information.

The other times you provide information, you are trying to get something. You may be trying to establish new or additional lines of credit, enticing new ownership contributions, or simply showing that you are capable of handling a lease commitment. In each case, you want the person reading these financial statements to be impressed with your business.

In most cases, you need the details of your financial situation. For instance, for new projects, you want to be able to determine their financial impact, in which case the "details" are really important.

Details, however, are not necessarily needed when you want to impress other people.

The two main statements are the income statement (revenues and expenses) and the balance sheet (assets and debts).

Income statements—The rules for preparing income statements differ from those of preparing balance sheets for outside eyes. Here are some tips:

1) Reduce details as much as possible. Consolidate the operating or income statement. The key numbers are sales, gross profit, inventory, wages, rents and other operating-type numbers.

There is no need to separate all of the different levels of payroll such as ownership and management. These numbers can be provided separately, if needed. You should also strive to reduce the number of lines of sales—consolidate it to one line if you can. You want to show that you have a viable operation, not to invite comment on a sideline sales category.

2) Separate core activities. Sometimes you'll need to separate items. Few businesses work on one idea at a time. They often mix different activities into the same operation. Examples of this include subleasing, renting signs, wholesale activity and sideline activities.

When one of these is combined to the core activity of, say, a mower rental business, you hide the true operational results of the main business. The other person reading your statement is not interested in sidelines; he or she is interested in the manner in which you make your money.

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Sometimes these little adventures cost us money, or are still in the development stages. This being the case, they make the core business look bad—when, in fact, it is doing well enough to support these outside activities. You need to show the reader of the income statement how well you are doing with the main business and how much it contributes to bottom-line expenses. You can show these other activities below the line called income from operations.

3) Use comparative information. Many outside readers are trying to determine trends in your business. Show growth rates and management accomplishments.

Commonly, companies show the prior year in their statements. There is nothing wrong with the consolidation of a number of years on one page. Here you can see how the company has grown and the cost controlling measures that you may have put in it.

Balance sheets—Not all of the same rules apply for balance sheets. Here some additional detail can be useful, but do not try to overwhelm the reader with too many details. Some tips:

1) Show the various assets you actually have. Show the key current items such as inventory, accounts receivable and cash. This will show the outside reader how liquid you are. Show your payables split among remittances required by governments and those to outside trade suppliers. If any money is due to the principals of the company, show these separately.

2) Reduce details in the fixed asset area to the main categories of: land, building, equipment and leasehold improvements. Group all of the accumulated depreciation and amortization together.

Outside readers should be able to easily extract how much you own and in what general categories it exists. They should be able to see how much you owe to outsiders and what type of outsiders they are. Finally, they should be easily able to determine how much you have invested in the business.

In the balance sheet, there is a delicate line of too much information and too little. Help the reader understand where your business is without trying to show them where every piece of stock is located.

Some don'ts—Avoid—at all costs—inflating sales and income to impress someone. First, the numbers will stop making sense to a skilled reader; second, by exaggerating, you might be opening yourself up to legal action. Certainly you are permanently losing all credibility with the outside reader.

Next, while non-cash expenses such as depreciation is tempting to exclude (after all, it does not result in cash), resist it. A skilled reader knows it should be there, and in its absence, will make assumptions that are not in your favor.

Resist the transfer of expenses from the income statement to the balance sheet. Accounting rules can tell you what expenses can be capitalized, but readers on the whole are looking for the "hard" assets. Certainly, set up a legitimate prepaid expense (where the value of the expense extends into future periods), but do not overdo it. Readers catch on.

Read your own statements and see if they are telling the story you want them to.

—The author is chairman of Padgett Business Services. This is one in a series of articles he is writing about accounting for LANDSCAPE MANAGEMENT.