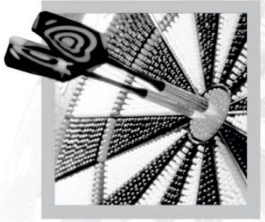


Keeping Our Local Businesses Strong: Effective Financial Management

There are 5 Key Components to EFM

- The Role Of Management and Cost Behavior
- Gross Margin Analysis
- Profit Improvement Strategies
- Key Performance Indicators
- Managing Cash Flow



The Role Of Management: What is the Key Financial Data for Business Survival?

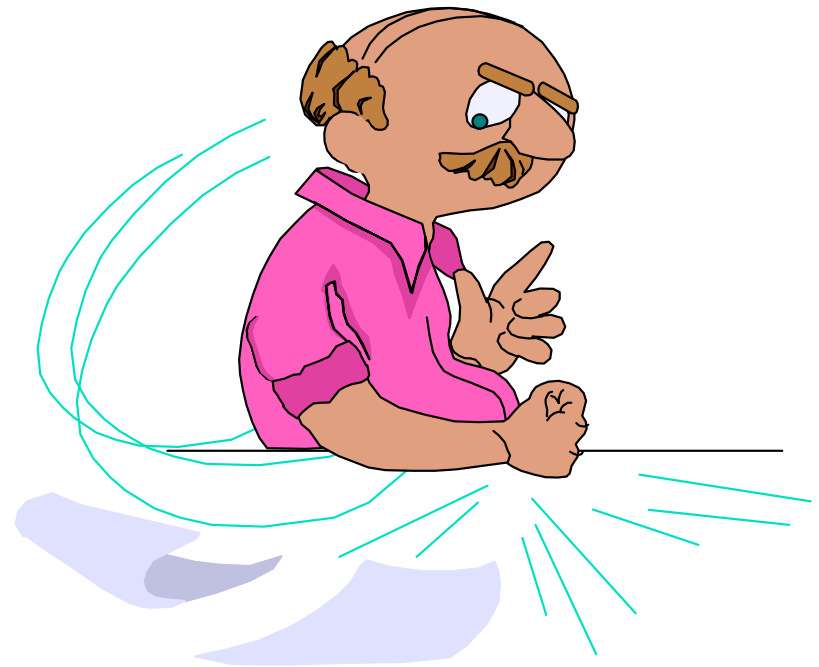
What Does Management Typically Look At?

- Bank account/cash balances
- Sales revenue and quantities
- Production
- Balance Sheet and/or Profit & Loss

Is this good enough? Let's take a look at an example...

A Case Study

A story of a
business person
who lost sight of
the true measure
of performance



Traditional Historical Data

	2005	2006	2007
Sales	800,000	740,000	735,000
Gross Profit	280,000	259,000	220,000
Expenses	160,000	175,000	196,000
Net Profit	120,000	84,000	24,000

New competition arrives

Cut prices to aggressively seek new customers, doubled advertising

Sales were monitored weekly and compared to the prior year. Team was busy, phone ringing, lots of inquires, they thought they were winning the

Issues (according to the *business owner*):

- Sales down by \$65,000
- Net income down by \$96,000
- Busier than ever and working harder...the numbers HAVE to be wrong*

Looking beyond the numbers...

Year	Invoices	Customers	Sales/ Invoice	GP/ Invoice	Sales/ Customer	Invoice/ Customer
2005	2286	181	350	122	4420	13
2006	2651	205	279	98	3364	13
2007	3587	318	204	61	2311	11

What happened?

By focusing only on sales, he:

- Gained new customers who were price sensitive and bad payers
- Compromised service value for price

Recovery?

In 2008, they:

- Set prices to achieve a 38% gross profit
- Developed a customer service plan using feedback from a Customer Advisory Board
- Applied a strict credit control policy, getting rid of the non-paying/performing customers
- Re-allocated advertising dollars through improved quality and frequency of customer communication
- Identified and measured daily Key Performance Indicators such as the number of sales and the average value of each sale

The Result

- Active customers fell from 318 to 232
- Average sales per customer rose from \$2,311 to \$3,420
- Gross profit per customer rose to \$1,322
- Operating profit in 2008 increased from \$24,000 to \$97,000
- Operating profit in 2009 increased to \$132,000

(Ir)rational Reason—Why Do Things REALLY Happen In Business?

Falling sales

Because of new competition?

OR

Because we lost customers due to indifferent service?

Falling sales per customer

Because of the recession?

OR

Because we've made too many mistakes, giving our good customers away to the competition?

Not meeting delivery times

Because a supplier has not provided a critical raw material?

OR

Because we failed to plan our materials requirement?

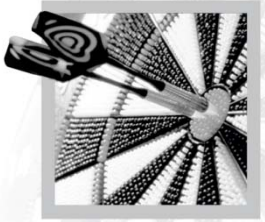
How To Manage More Effectively...

- Understand the numbers
- Once you understand the situation, you can investigate likely causes
- Never assume anything—
 - A good management information system is worth its weight in gold and can prevent mistakes from costly guesswork!

Focus On The Right Things

- If you are managing a business, you must manage the *activities*, that make up the business
- In order to manage these activities, you must first be able to *measure* them, because...

What gets measured, gets managed



Cost Behavior: What Causes Your Costs To Rise And Fall?

Understanding And Analyzing Costs

- *Activities* drive costs
- Traditional accounting systems monitor *consequences* rather than *causes*
- It's important to know where each particular cost arises in the business process
- How does the activity (and related cost) contribute to the objective of making money?

Defining Costs

Costs can be assigned to the following categories:

- Variable Costs
- Activity-Based Costs
- Fixed Costs

Applies to both COGS and Administration expenses

Most accounting systems do not classify expenses on the basis of their variability. Options for tracking:

- Re-organize chart of accounts
- Customized class tracking
- Export to Excel spreadsheets

Variable Costs

- These costs vary in direct proportion with sales revenue.
 - Sales commissions or royalties
 - Credit card processing fees
 - B&O taxes
- How can you tell if it's variable?
 - Constant ratio over various levels of sales revenue
 - If the ratio changes, it's most likely activity-based

Activity-Based Costs

- These costs vary in nature, but not directly in proportion to sales revenue.
 - Advertising
 - Wages
 - Utilities
- Driven by various activities within the business
 - Supports current or future sales transactions
 - Exhibit little or no correlation with current levels of sales revenue
- Used to classify all expenses clearly not variable or fixed

Fixed Costs

- Costs incurred irrespective of whether or not any sales are made
 - Rent
 - Insurance
 - Salaries
- Usually associated with the physical capacity of the business or are contractual in nature
- Fixed costs are only fixed to a certain capacity level

Understanding Cost Behavior: Some Examples

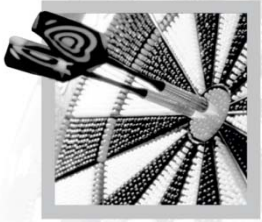
Some costs can be either fixed or variable depending on circumstances

We'll look at three examples:

- Cost Of Goods Sold
- Rent
- Wages

Cost Behavior

- It's critical to understand:
 - Different types of costs: variable, activity-based and fixed
 - The cost drivers in your business - cost “creep” is a classic reason for underperformance of small businesses



Gross Margin Analysis: What You Need To Do To Hit Your Profit Target

Gross Margin Analysis

- All costs and revenues are ultimately driven by two things
 - Products or services provided
 - Customers
- It will tell you:
 - Which of your products/services are the most profitable?
 - Which types of customers are the most profitable?
- Gross Margin & Gross Profit are the same

Computation

- To compute gross margin:
 - $\text{Sales} - \text{Cost of Goods Sold} = \text{Gross Margin}$
- Gross Margin %:
 - $\text{Gross Margin} / \text{Sales} = \text{Gross Margin \%}$

Used in Decision-Making for Products/Services

	Formula	PRODUCT			Total
		A	B	C	
Sales %of total	a	144,000 25%	180,000 31%	250,000 44%	574,000 100%
GM%	b	33%	50%	20%	
Gross Profit (GP) %of total	c = a x b	48,000 25%	90,000 48%	50,000 27%	188,000 100%
Average price per item	d	12	6	15	9.78
# of items	e = a / d	12,000	30,000	16,667	58,667
GP per item sold	f = c / e	4.00	3.00	3.00	3.20
Ave. inventory on hand %of total	g	21,000 16%	85,000 65%	24,000 18%	130,000 100%
Inventory turnover (days)	$(g \times 365) / (a - c)$	80	344	44	123
ROI	i = c / g	229%	106%	208%	145%

Customer Profitability Analysis

- What is a customer group?
- Different, clearly defined sectors you work with such as:
 - Students vs. Families vs. Retired Couples
 - Businesses vs. Individuals
 - Retail vs. Wholesale
 - Commercial vs. Residential
- May reveal noticeably differing costs associated with serving particular groups

Analyzing The Numbers

	Formula	CUSTOMER GROUPS			Total
		D	E	F	
Sales	a	250,000	200,000	300,000	750,000
% of total		33%	27%	40%	100%
GM%	b	33%	50%	25%	34%
Gross Profit (GP)	c = a x b	82,500	100,000	75,000	257,500
% of total		32%	39%	29%	100%
# of invoices	d	1,500	2,500	2,500	6,500
Average value / invoice	e = a / d	\$167	\$80	\$120	\$115
GM% per invoice	f = c / d	\$55	\$40	\$30	\$40
Average amount outstanding	g	60,000	80,000	85,000	225,000
% of total		27%	35%	38%	100%
A/R turnover (days)	h = (gx365) / a	88	146	103	109
ROI	i = c / g	137%	125%	88%	114%

What Sales Do I Need To Break Even?

NET INCOME	0
ADMIN/OVERHEAD	50,000
GROSS MARGIN @35%	50,000
SALES TO BREAK EVEN (100/35 X GP)	143,000

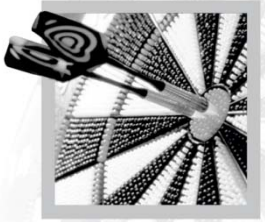
- X-check = $\$143,000 \times 35\% = \$50,050$ (rounding diff)
- Gross margin benchmarks – available by industry
- Break-even is useful for:
 - New products/service lines
 - Feasibility of an investment in assets
 - Hiring decisions

What Sales Do I Need To Achieve A Specific Profit?

NET PROFIT	10,000
+ADMIN/OVERHEADS	50,000
GROSS PROFIT @ 35%	60,000
SALES NEEDED ($100/35 \times \text{GP}$)	171,600

To review...

- 3 Different ways to use Gross Margin Analysis:
 - Overall business
 - Product/service groups
 - Customer groups
- What you can measure, you can manage



Profit Improvement Strategies: How To Make More Money

The Definition of Insanity

Doing the same thing over and
over again....

but expecting different results

The 4 Ways to Grow A Business

The number of customers you start with

-

Those that you lose each year

+

Those you pick up

=

Your total number of customers

X

The number of times they deal with you each year

=

The number of transactions

X

The average value of each sale

=

Your Total Revenue

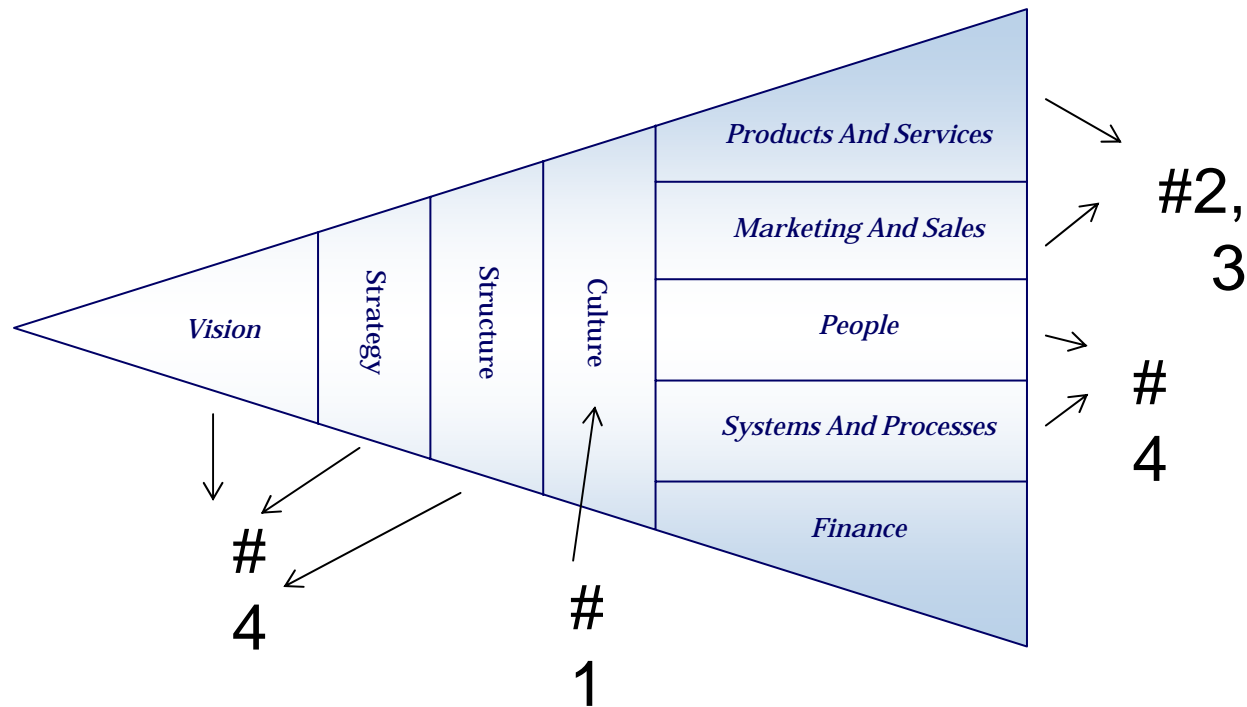
#1 Increase the number of customers of the type you want

#2 Increase the number of times customers come back

#3 Increase the average value of each sale

#4 Increase the effectiveness of each process within the business

Assessing Business Performance - The Framework



SMART Strategy

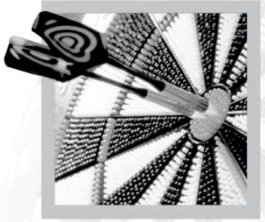
S specific, significant, stretching

M measurable, meaningful, motivational

A agreed upon, attainable, achievable, acceptable,
action-oriented

R realistic, relevant, reasonable, rewarding, results-oriented

T time-based, timely, tangible, trackable



Key Performance Indicators Tools For Managing Your Business

What Is A Key Performance Indicator?

A measure of how well business processes are being performed

They may be measured both qualitatively and quantitatively

The Benefits Of KPIs In Your Business

- What you can measure you can manage!
- Align the business's long term goals with short term performance
- Provide milestones while working towards long term objectives
- Promote understanding among the team of the areas critical for success

Critical Success Factors (CSF)

- Necessary processes to fulfill the Vision
- What is essential to get right...from the customer's point of view
- KPIs measure the Critical Success Factors

Identifying Critical Success Factors

Which processes are:

- Vitally important to achieving the Vision?
- Most important to the customer?
- Have the greatest impact on cash flow?
- Have the greatest impact on return on investment (ROI)?
- Directly impact team morale?

Different Levels Of KPIs

- Enterprise level (monthly reporting)
 - e.g. profit and cash flow variance from annual budgets
- Business unit level (daily or weekly reporting)
 - e.g. average transaction value, transaction count, number of complaints received
- Operational level (daily—or sometimes hourly—reporting)
 - e.g. the weight of coffee beans roasted per hour, the number of sales calls made per day

KPI Data Should Be Easy To Gather



- Cost/Benefit
 - Benefit the information will provide outweighs the cost of obtaining and maintaining the data
- Collect it in the most efficient manner

Where Would KPIs Be Used?

KPIs should be used within all major Critical Success Factor areas:

- Finance
- Production/Services provided
- Customer relations
- People development


Cash Flow As A CSF

Cash Flow

Measure
both sides



- (KPI 1) Days in receivables



- (KPI 2) Clients lost to aggressive collection policies

Cash Flow - Component KPIs For Gross Sales

(KPI 3) Gross Sales



← **Cash Flow** →

Measure
both sides

(KPI 4) Net Margins

(KPI 5) Gross Margins

(KPI 6) Cost Per Sale

(Component KPI 3a)
Number of Leads
Generated



- *How do we get new work?*
- *Sales processes, scripts & methods*

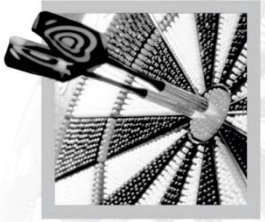
(Component KPI 3b)
Leads Converted
Into Sales



- *Variances in sales and conversions between sales people*
- *Which products work better & why?*

To Review...

- KPIs are the first step towards business performance management
 - Step 1: KPI design
 - Step 2: KPI measurement
 - Step 3: Analysis and action towards your vision
- KPIs are instruments for effectively managing the business
- It is the **ACTIONS** that provide performance results



Managing Cash Flow: Practical Tips For Improving Your Cash Flow

Cash Flow Is Critical To Business Survival

- A common scenario:
 - Insufficient cash reserves
 - Cannot pay due bills
 - Business fails
- No cash, big crash!
 - Sophisticated business processes, & good products and systems, are not enough if you have no cash
- BUT.... many small businesses don't have a cash flow plan & don't manage their cash flow

Key Requirements Of Your Cash Flow

Cash flow should be:

- **Positive:**

Cash Inflows – Cash Outflows = +Net Cash Flow

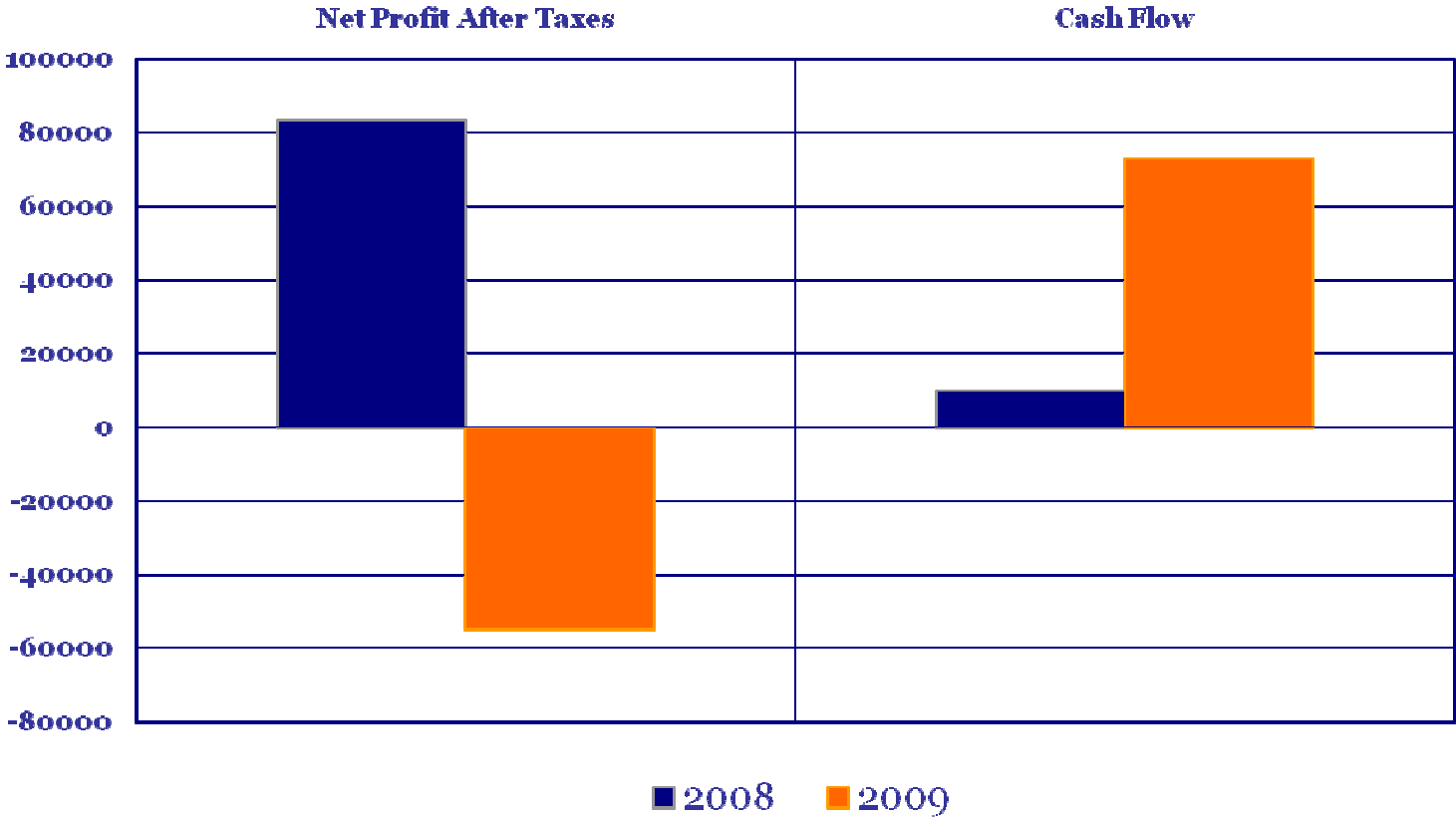
- **Available:**

Sufficient cash flow in liquid assets to meet financial obligations

- **Timely:**

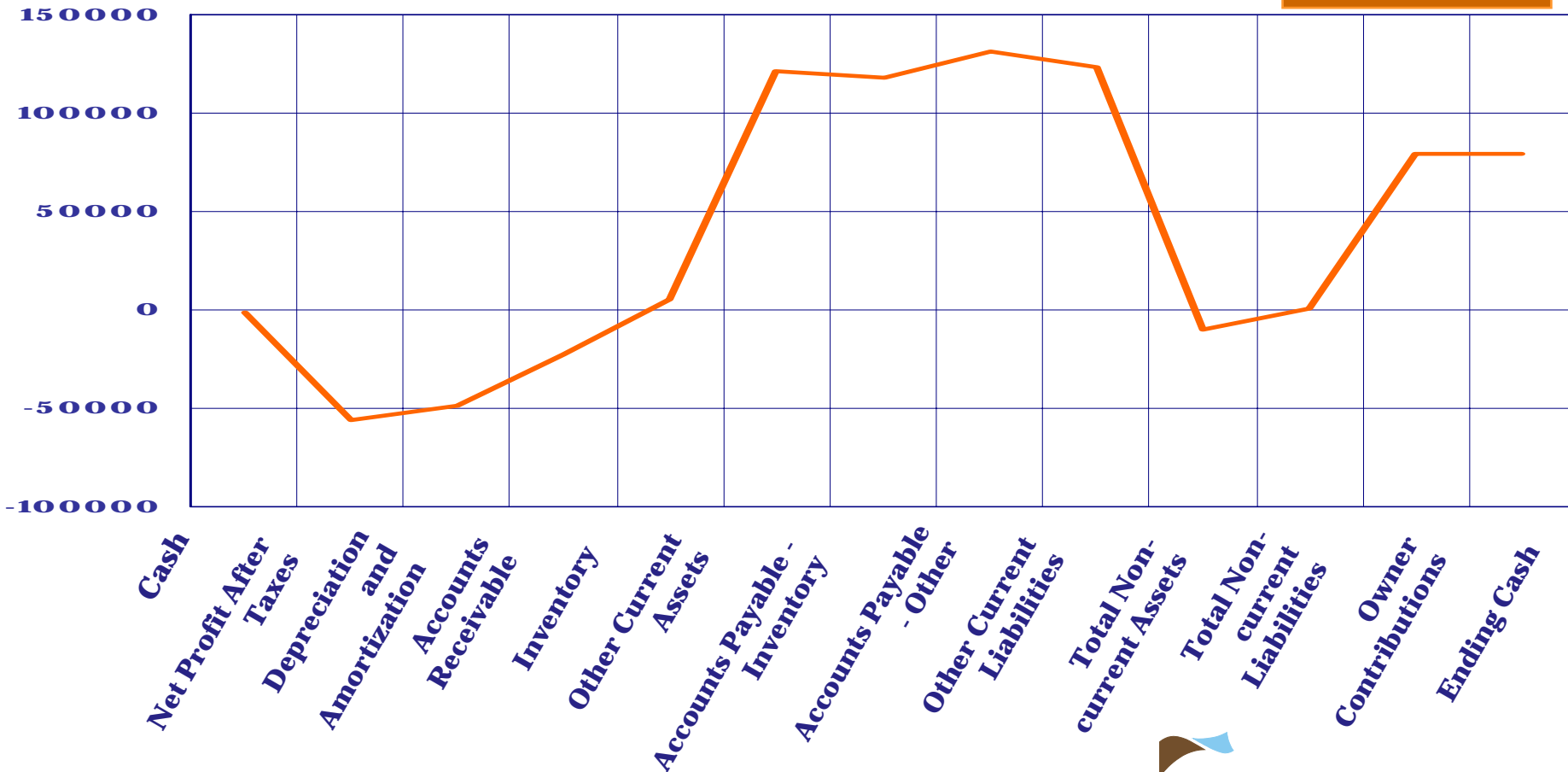
Cash Inflows must come in before Outflows are due

Financial Result - Profit And Cash Flow



Financial Result - Where Did My Cash Go?

2006



Summary

- Cash Flow is an essential factor in the ongoing health of a business
- Cash flow must be **positive, timely** and **available**
- Create a Cash Flow Plan / Forecast
- **Leverage effectively**
- Measure and monitor your plan on an ongoing basis so you can manage the business proactively

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