LIFETIME, INTERACTIVE BUSINESS GUIDE

A TEN-BOOK SERIES ON TOP BUSINESS FUNCTIONS

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Growth & Business Coach

David Gabbert

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INITIATE EFFECTIVE FINANCIAL MANAGEMENT TOOLS

A TEN E-BOOK SERIES

AUTHOR DAVID GABBERT

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INITIATE EFFECTIVE FINANCIAL MANAGEMENT TOOLS

Introduction

Imagine you are flying a plane in the dark without an instrument panel. As you zoom along at 550 miles per hour, all you can see is an endless night sky—and between you and the horizon, somewhere, is a mountain peak. You don't know when it will come; only that you need to change course before you hit it. Without an instrument panel, all you can do is cross your fingers and hope that you will see it in time.

That is what you are doing if you are operating a business without monthly financial statements. As foolish as that sounds, thousands of small business owners make business decisions every day based on the amount of cash they have in their checking account or the amount of credit open on their credit cards. And when an obstacle appears in their path, it's too late to divert course.

In order to successfully pilot your company to financial success, you need to understand how to make and read financial statements. Those numbers tell you every month how you have performed and how you are progressing, and they give you good information on which to base decisions.

In this e-book, you will acquire those skills. We'll start, though, with a standard disclaimer: If you do not understand financial statements or need help in establishing an accounting system for your company, it is important to seek help from a qualified accountant. There are also many helpful books in print that will aid in your education, as well as helpful online content that at www.Lowe.org. Some of the information in this chapter comes from business accounting bibles such as *Accounting for Dummies*, by John A. Tracy, and *The Successful Business Plan*, by Rhonda Abrams.

That said, you will find this e-book helpful. We begin by introducing the basic steps to a viable accounting plan for your business, and cover the steps you need to take to make a wise financial decision. The goal is for you to be able to keep track of your company's financial plan, find its leaks and cash cows, and set forth a strategy for growth. At the end of the e-book, you will find an exhibit of financial statements, a glossary, and a discussion of common financial ratios used as management tools.

Win at Biz Scorecard

Wait! If you are unfamiliar with the balance sheet, income, and cash flow accounting statements and functions mentioned above, STOP READING. Go to the appendix and review this information before continuing.

Accounting 101

A business is only as healthy as its financial performance. Tough, calculated business decisions have to be made everyday to guide the company to financial success. What would you do if you did not have the cash to pay your employees, suppliers, loan payments, or rent? How would you feel if you worked all year only to discover that at year's end, you lost money? Without adequate accounting information, how would you determine what went wrong or what needs to be corrected? Wouldn't it be better to avoid the catastrophe altogether with good planning and budgeting? Wouldn't it be better to have reliable information available daily (or at least weekly) so decisions could be made well before there is a serious financial problem?

In this section, you'll begin by creating and reviewing a financial statement. Short-term financial planning and the establishment of financial goals must be made using the numbers on this financial statement. Only then can you decide what actions are needed for your financial goals to be realized.

A word to the wise: Don't go into denial. Business owners who ignore their financial statements, hesitate to establish financial goals, or avoid corrective measures *will* go out of business. Accounting can be tedious, and by nature, it involves confronting uncomfortable truths. As the adage says, "Numbers don't lie." Your role as a company leader is to deal with financial problems right away. Dealing with them will be less painful in the short run than waiting until the problem creates a crisis.

Win at Biz Scorecard

- **Do you review accurate financial statements every month?**
- **Do you make decisions to improve the numbers?**
- **Do you put those decisions into action?**
- **Have you developed a board of advisors? Think of your financial statement as a report card that is grading you on both how well you are managing the business and how effective you are at beating the competition.**

Before You Start: Common Accounting Mistakes

- Not following formalized accounting procedures
- Not hiring a good accountant
- Not seeking professional accounting and financial advice
- Not balancing cash and making corrective entries on a monthly basis
- Not having an efficient filing system
- Not making use of accounting software programs
- Not backing up data from software programs
- Operating with a vague or no financial plan or budget
- Failing to budget for advertising to grow revenue
- Making no plan for profit projections or cash flow
- Forgetting to budget for taxes
- Assuming revenue growth will generate more cash
- Not managing the asset or liability accounts
- Not knowing or managing the breakeven point
- Not managing the gross profit margin

What's in a Financial Statement?

The three most important financial forms you will use will be the balance sheet, the income statement, and the cash flow statement. Most financial statements are kept to make tax preparation easier. Those general statements serve a function, but may not provide enough information to let you make day-to-day financial decisions. Instead, you may also want to consider using *internal statements* that provide you with a better financial picture of what drives your company's profit.

In Example 1 on page 8 you will see an example of an *internal profit report statement* that uses margins, fixed and variable expenses, and operating profits. This statement will give you a clear picture of your revenue-driven expenses. The term margin used in this financial statement refers to an amount equal to all variable costs deducted from sales revenue; variable costs include both the cost of goods sold and all other variable costs that are revenue-driven. For example, sales minus cost of goods sold equals gross profit margin. Gross profit margin minus variable expenses equals margin. An example of additional revenue-driven variable expenses could be delivery expenses and sales commissions.

Keep in mind that in a retail or distribution business, the cost of the finished product, or cost of goods sold, is the largest revenue-driven variable expense (i.e., the more you sell, the more you've spent to supply those goods). In a manufacturing business, the "cost of goods sold" expense number is a bit more complicated to compute. Typically the "cost of goods sold" expense consists of the cost of raw materials, the payroll for production related labor, and the variable and fixed production-related costs to manufacture the product. Variable production-related costs would be any expense that varies directly with the quantity of items manufactured. Fixed production related costs would include salaries for supervisory production employees, occupancy costs, and depreciation expense of the manufacturing equipment.

A service business, on the other hand, may develop a "cost of sales" expense (rather than "cost of goods sold") consisting of revenue-driven variable expenses that are necessary to deliver the service. For example, "cost of sales" in a lawn maintenance business would include expenses such as materials (fertilizer and herbicide), production related labor costs, fuel, and depreciation expense for the trucks and equipment. A service business such as an accounting firm or web design service whose product is solely comprised of people service (rather than a combination of products, equipment and labor) typically does not have a "cost of goods sold" category. In these types of service businesses, the labor is accounted for as an operating expense.

Remember, in an internal profit report, regardless of how you compute your gross profit margin, you must also deduct the additional variable expenses to compute your final margin. This statement gives you a clearer picture of how operating expenses behave relative to sales activity. Then deduct your fixed expenses from the margin. The resulting operating profit (which is different from net income) does not include interest expense from investments or taxes. *The sole purpose of the internal statement is to re-organize the numbers to help you analyze profitability.* In addition, this statement can be broken down further to express unit sales as well as various profit centers. Most businesses derive revenue from a variety of profit centers. For example, a distributor of appliances may generate revenue from a retail division selling directly to the public, a contractor division selling directly to home builders, and a service division offering a repair service to homeowners. The profit for each division can be analyzed by preparing an internal statement, as illustrated in Example 1, for each revenue source.

If you start keeping an internal profit statement, you can include whatever additional numbers will help you daily—and stay focused on what is really driving your company's operating profits. Think about what those numbers might be. For a manufacturing business, one may be the number of finished products coming off of the assembly line. For a retail business, possibly it is the daily sales, daily number of unit sales, average dollar amount of the daily sales, and the gross profit. For a service business, it could be the number of clients serviced by each vehicle per day. It may be the average number of days you need to collect on your accounts receivable, or the amount of cash you generate on a daily basis.

Whatever daily numbers you establish as a spot check of the financial health of your business, having these numbers as a daily reference will help you make adjustments more quickly as you move toward your financial goals. In Example 1, you'll see an example of such a statement. Don't worry about its content for right now—we'll explain it fully very soon.

Win at Biz Scorecard

- **Do you utilize internal statements that separate variable profit-driven expenses from fixed expenses to help you make financial decisions?**
- **Have you developed a daily matrix of numbers to spot-check your progress?**

Example 1: Internal Profit Report

Income Statement for Year end 12/31/2007

Sales Volume	**110,000 units**		
	Per Unit	**Total**	
Sales	$1,500	$2,000,000	
Less: Cost of goods sold	($900)	($1,200,000)	60%
Gross profit margin	$600	$800,000	40%
Less: Variable expenses	($187)	($250,000	12.5%
Margin	$413	$550,000	27.5%
Less: Fixed expenses	($337)	($450,000)	22.5%
Operating profits	$76	$100,000	5%

Income Statement for Year end 12/31/2008

Sales Volume	**110,000 units**		
	Per Unit	**Total**	
Sales	$1,545	$2,020,000	
Less: Cost of goods sold	($896)	($1,172,000)	58%
Gross profit margin	$649	$848,000	42%
Less: Variable expenses	($170)	($222,200	11%
Margin	$479	$625,800	31%
Less: Fixed expenses	($337)	($450,000)	22.3%
Operating profits	$142	$175,800	8.7%

Step 1: Establish Your Accounting Method

One of the first decisions you will need to make is whether to set up your books on an *accrual basis* or a *cash basis* method of accounting. If you decide to conduct your business on a cash basis, you will not enter your sales until you have been paid. In other words, if you make a sale in June for $1,000 but you do not receive payment until August, you will not enter the sale until August. Expenses are entered as they are paid. Cash basis accounting gives you a clear picture of the company's ability to meet its financial responsibility.

Accrual basis accounting enters the sale and the expense when the transaction takes place rather then when the cash changes hands. In the above example, the $1,000 sale made in June would be credited to sales in June and debited to accounts receivable while the debited expense is credited to accounts payable. Accrual basis accounting gives you an accurate picture of the performance of the income or loss activities and balance sheet accounts at any moment in time.

Step 2: Find Your Breakeven Point

A good place to start managing the financials of your business is with determining your *breakeven point*. Breakeven points will be expressed in terms of the revenue required to pay all of the fixed and revenue-driven expenses. Revenue-driven expenses are all costs of goods sold, as well as direct and variable expenses associated with making the sale.

Once you have determined all of your revenue-driven costs and fixed operating costs, you can determine your breakeven point in terms of required revenue, and analyze how changes in any of your categories (pricing, cost of goods sold, direct expenses, and fixed expenses) will affect your breakeven point and profitability. Let's look again at the profit report that we just saw a moment ago.

Internal Profit Report

Income Statement for Year end 12/31/2007

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	Per Unit	**Total**	
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For the year ending 2007, a company, "Gamma's," revenue (at specific selling prices) and the cost of the products sold yielded a 40 percent gross profit margin for the company. Gamma experienced direct expenses that ran 12.5 percent of sales. Fixed expenses were $450,000. So, what is Gamma's breakeven point?

Your answer is $1,636,363. Your formula for computing your breakeven point in this example is $450,000 (fixed expense) divided by 0.275 (100 minus the cost of goods sold percentage of sales (0.60) less the variable expense percentage of sales (0.125).

Once you know your breakeven point, you can calculate the sales required to break even, as well as see how small financial adjustments will raise or lower your breakeven point and operating profit. For example, if competition forces prices down, your gross profit margin will fall, and your breakeven point (i.e., the amount of revenue required) will rise. If the price of raw materials or vendor costs increase, your gross profit margins will decline and your breakeven point will increase. If some of the revenue-related direct costs increase, again the amount of revenue required to break even will increase. The same scenario is true if any of your fixed costs increase.

Any improvement in your breakeven point drops straight to the bottom line. So, you will want to focus on changes that will lower your breakeven point (and therefore increase your operating profit). To manage your operating profit effectively you must understand how the smallest of changes affect the breakeven point. For example, in Example 1 for the year ending 2008, you can see how very slight changes have increased the operating profit by $75,800. That is a 75 percent increase in 2008 operating profits compared to 2007, with no corresponding increase in the number of units sold. The increase was accomplished by raising prices by just 1 percent, lowering the cost of the products sold by a little over 2 percent, and decreasing the direct expenses from 12.5 to 11 percent of sales. Notice how the increase in the margin of $75,800 all drops directly to the bottom line.

You must know your costs like the back of your hand. If you do not keep current information about changes in your costs, you will not be able to manage your breakeven point and operating profits. For example, let's say your company, "Sigma," has unit sales of $1,000, a cost of goods sold of $600 (yielding a gross profit margin of $400 per unit). If the cost of the product goes up by $50, the gross profit margin will decrease from $400 (40 percent g.p.m.) to $350 (35 percent g.p.m.) and the operating profit will decrease by $50 per unit. You will have two options to restore the lost $50 in gross profit margin. You can leave prices the same and increase sales by 14 percent at the new 35 percent g.p.m. or you can raise prices by 5 percent. Both options, or any combination of increasing sales and a partial price increase, will restore the lost gross profit margin. In either case, you need to know right away how the rising costs affect Sigma's profitability, because the change eats into your daily profits.

Another way to manage your breakeven point and operating profits is to examine each unit sale, regardless of price, and determine how each unit sale drives the direct cost of each related expense. For example, for every unit sale, what is the unit cost incurred for the sales function? What is the unit delivery cost incurred? What is the unit advertising cost? Once you have determined all of your direct unit costs, you will be in a much better position to manage your breakeven point and operating profits. As you see increases in your direct unit costs, you can react more quickly by either increasing prices or unit sales.

You can carry out yet another management technique using fixed costs. For example, in the internal statement, Example 1, the revenue in 2007 was 4.444 times the fixed expenses. In order to maintain profit margins of $100,000, the company will need to maintain fixed expenses at a multiple of 4.444 to revenue. If fixed expenses increase to $500,000, then you will have to adjust either pricing or the number of unit sales to increase revenue to a multiple of 4.444 times the increased fixed expense number. In order to maintain the present breakeven point and operating profit, the multiplier of 4.444 must stay intact.

The important point is that you need to know your breakeven point and the costs associated with driving revenue, and develop internal statements to manage them.

Win at Biz Scorecard

- **Do you know what your breakeven point is?**
- **Do you continually search for ways to lower your breakeven point?**
- **Have you identified all of your costs that drive revenue?**

Setting Your Budgets and Targets

The actions that affect your financial statement are old news because financial statements tell you what has already happened. If you want to affect your future financial statements, you will have already implemented the advice in Step 2, and established internal statements (with the knowledge of your breakeven point) for the purpose of budgeting.

The next step—the act of developing formalized budgeting—will force you to analyze your past financial history, establish specific financial goals for the future, and develop detailed action plans for how to get there.

Every company needs financial goals and targets that are shared with everyone throughout the organization. You must determine where the company is going in terms of pricing, sales, expenses, your margins, operating profits, and cash flow. There are many reasons to budget; there are also many benefits to the company derived from budgeting. When you are developing your budgets, it can be prudent not to over-build for growth. Remember that it is usually more difficult to manage revenue growth than it is to control expenses. Consider the following:

- Developing *budgeted profit models* for the planning of operating activities provides an opportunity to plan for amount of profit you want to make. It will force you to make decisions about how to change the numbers and how you are going to get there.
- Developing a *budgeted balance sheet* shows the connections between your asset and liability accounts. You must demonstrate how decisions that have created changes in your profit model are going to affect the various accounts on your balance sheet. For example, will you need to keep more inventory or raw materials on hand, increasing the inventory balances? What will the effect be on accounts receivable balances? Will you need to replace or add any new equipment; if so, how will they affect your fixed asset account?
- Developing a *budgeted cash flow statement* will aid you in forecasting the company's cash flow needs to accommodate the changes in your profit model and the changes you forecast for your asset and liability accounts.

Budgeted goals can be broken down into monthly or quarterly targets, allowing management to react more quickly to the changing economic and competitive environment. Budgeting provides an opportunity to plan for sources of additional cash that may be needed, plan for the replacement or addition of new equipment, analyze the best way to maximize a return on assets and equity, review finance decisions regarding short- and long-term debt levels, owner disbursements, and investments. It also allows you to review inventory turnover ratios (and thus implement) controls to keep monthly inventory levels in line, review the average number of days you are carrying accounts receivable (and thus initiate controls to lower your carry time), and devote more time and thought to the entire process that will improve the accuracy of your forecasts. You will be able to develop financial targets against which manager and company performance can be measured, improve communication among departments, allowing an opportunity for everyone's ideas to be heard, and establish a format for motivating employees to achieve the budgeted targets.

All of the budgeted financial statements, the decisions that have been made to improve future performance, and the detailed plans of action that need to be implemented all need to be in writing. If it is not written, it is not a plan. Think of the budgeted financial models as blueprints for achieving operating profits, healthy financials (a.k.a., the balance sheet) and positive cash flow. Good financial planning must include all three statements. Many business owners stop short of looking at anything but than their income statement, failing to consider the effects on their assets, liabilities, and cash flow. Think of the budgeted models you build as a highway connecting the profit, financials, and cash flow. The financial details required for your internal budgeting statements are provided below in Examples 2 and 3.

Example 2: Budgeted Profit Report

Sales Volume	Actual for Year Just Ended		Budget for Coming Year	
Sales	$2,500,000		$2,800,000	
Less: Cost of goods sold	($1,500,000)	60%	($1,652,000)	59%
Gross profit margin	$1,000,000	40%	$1,148,000	41%
Less: Variable expenses	($250,000)	10%	($252,000)	9%
Margin	$750,000	30%	$896,000	32%
Less: Fixed expenses	($625,000)	25%	($600,000)	21%
Operating profits	$125,000	5%	$296,000	10.6%

Example 3: Budgeted Cash Flow Report for Coming Year

Budgeted Profit	$296,000
Accounts Receivable Change	($50,000)
Inventory Change	($18,000)
Prepaid Expense Change	$4,000
Depreciation Expense	($26,000)
Accounts Payable Change	($35,000)
Budgeted Cash Flow	$171,000

Planning to Achieve Your Budgeted Targets

During the planning stage of your budgeting process, you must entertain a host of variables that could affect your profit and cash flow. Remember that everything you do affects your financials. The efficiency of your business systems in satisfying and keeping customers, the effectiveness of your interviewing, hiring and training systems to develop a productive work force, the effectiveness of your marketing program, and the effectiveness of management all affect the numbers. Every action of every employee every day along with every business decision will determine the outcome of the numbers on your financial statements.

During the planning of your budget, examine all of the variables that impact revenue, margins, expenses and your corresponding asset and liability accounts; then implement action-oriented plans to get you there. In the next section of this e-book, we'll talk more about how to tweak each of these aspects to create a healthy financial forecast for your company.

Short-circuit Procrastination before It Happens

It is prudent to develop a board of advisors whom you trust and who have proven business backgrounds. Your board of advisors can become an invaluable asset in the area of quarterly financial reviews and on the establishment of financial goals. It becomes a lot more difficult to delay corrective financial actions or sweep inappropriate decisions under the rug when you know you are accountable to a board of financial review.

Consider utilizing students in graduate programs at some of the better-known business schools such as Yale, MIT, or Dartmouth. Many of these students are anxious for the opportunity to do financial analysis work for free as a class project just to get some real world business experience.

Use Your Budgets to Improve Revenue

In the following several sections, we will be covering some key considerations to include in any assessment of your financial health.

The first and easiest way to boost your bottom line is to boost your revenue. Specifically, improving the quality of your product or service, improving the effectiveness of your marketing program, or inventing more ways for your customer to interact with you can all generate more revenue.

Perhaps you need to improve or change your business processes to beat the competition in the way you develop leads. Focus on strengthening the perception of your brand—determine what your customer wants and train your employees to provide it at every customer touch point. Many times, if you get rid of purchasing frustrations and make your product or service easier to buy, you can sell more. By seeing the world through your customer's eyes, you can develop business processes to satisfy those wants better than the competition does. You'll create more remarkable experiences with your customers and, as a result, increase your word-of-mouth advertising. The goal is to improve brand loyalty and thus increase revenue.

Look at people-skills, too. Improving the professionalism and sales skills of your salespeople can boost revenue, too, by enabling them to close a higher percentage of sales. Improving the knowledge and skills of your customer service team will generate more satisfied customers and encourage repeat business.

Consider what you're selling and to whom. Maybe you can improve revenue by adding new products or services, expanding into new geographical markets, changing locations, or marketing to a new group of customers. Many times you can increase revenue by changing the inventory mix; you could improve the list of best sellers and move the slow sellers out. You might increase the dollar amount of your average sale by making changes to your sales system as well as your inventory mix.

Finally, examine your price points. Many times increasing price points may increase revenue—but possibly lowering prices may increase revenue, too. Merchandising your price points by lowering prices to increase demand on slow-moving products and increasing prices on your best moving products can both increase revenue.

In short, focus on all of the factors that can impact revenue; then take action to implement them.

Win at Biz Scorecard

How many creative ideas can you come up with to increase revenue?

Use Your Budgets to Improve Gross Profit Margins

The gross profit margin is affected by the selling price relative to the cost of the goods sold. The costs of goods sold could be the cost of the products you are selling, the manufacturing costs of the products you are building, or the variable costs related to the service you are providing.

1. The Lower-Costs Approach

To increase gross margins, look at ways to lower the costs that affect the product or service you are selling. If you are operating an inventory-related business, you can negotiate lower prices by purchasing in higher quantity or purchasing closeouts. Many times if you purchase under a private label, you do not disrupt distribution and can obtain better pricing. Consider buying your product at a different price point where there is not as much competition and the margins are more generous—you can often buy from different manufacturers or possibly overseas manufacturers where labor costs are lower, and you can generate a better value in the marketplace to create larger margins. You can also increase gross margins by lowering your freight costs. In fact, never stop looking for ways to reduce your freight costs.

In a service business, usually your service-related labor expense, costs for service-related materials, and gasoline (if you operate a fleet of service vehicles) will compose the majority of your variable costs. Efficiencies that lower these costs will increase gross margins. In order to lower costs on labor relative to revenue, you will need to focus on productive hiring and training procedures and creative, motivational financial incentives to increase the billable revenue per man-hour of labor costs. Strive to lower your service-related material costs and increase the efficient use of materials to reduce waste. If you are operating a fleet of service vehicles, develop routing efficiencies and GPS navigation to control and improve the efficient use of time and gasoline. Also, look at both your hiring and training systems to improve productivity of finished product per man-hour. Consider providing financial education and incentives that engage your production people to work for bottom-line results. Monitor the productive return of your equipment relative to the competition.

Finally, in a manufacturing business, look for ways to both drive the costs of your raw material lower than the competition's, as well as ways to improve the efficient use of raw materials to eliminate waste.

In any kind of business, study the efficient use of physical space to lower your occupancy costs.

2. The Raise-Prices Approach

On one hand, you can increase gross margins by implementing cost efficiencies and production incentives, but on the other hand you also have the option to increase prices to drive margins higher.

Obviously, raising prices will increase gross margins, but there is usually competition to consider. Many times the price sensitivity levels of your customer may be more of a limiting factor on price increases than your competition. Sometimes price increases will have a counter effect and decrease revenues due to decreased demand; however, many times prices and gross margins can be increased by raising the quality of the product or improving the way your systems sell and deliver the product relative to the competition.

Price can become secondary in importance, however, when the consumer is coming to you for better quality or reduced purchasing frustrations relative to the competition. In fact, many customers will willingly pay more for better service, a superior quality product, convenience, or even prestige. Differential pricing or varying the margins of different items based on the value or demand the consumer places on them will allow you to increase profit margins.

The biggest drag on many small businesses' gross margins is the dollars they give away through discounting prices when they sell the product. Teach your sales people to sell on the benefits, not on price. If you tend to discount prices to close sales: stop! Only give discounts to the five percent of your customers who try to negotiate and require a discount in order to close the sale.

Win at Biz Scorecard

Dollars generated from increased gross profit margins drop right down to the bottom line. Make a list today of all of the different ways you can improve this number!

Convert Fixed Costs to Variable Costs

The more expenses you can tie to revenue, the easier it will be to control your expenses and your bottom line. That is, it makes good business sense to turn as many of your expenses into direct, or "variable" costs (The terms are interchangeable, but we will use the term *variable* in this e-book.) Variable costs that are structured properly are revenue-generated expenses. Isn't it more beneficial to incur 50 cents of expense if it has generated one dollar of revenue, as opposed to a fixed expense that is incurred month after month without regard to how much (or little) revenue you earn?

The most common expense item that can be restructured from fixed to variable expenses is your sales expenses. Switching salespeople from salary to full or partial commissions is a great way to create revenue-producing incentives, thus moving a fixed expense to a variable expense. If you have salespeople who are receiving less than half of their income from commissions, consider changing how you compensate them.

In a service business, you might switch over as much of your production labor costs as possible from a fixed salary to a compensation program computed as a percentage of billable revenue produced or quantity of customers serviced.

In a manufacturing business, you may want to offer compensation incentives based on the number of widgets assembled. Substituting automatic salary increases or year-end gift bonuses with a reward-based bonus program directly related to revenue or bottom-line performance will divert money from fixed costs to variable expenses.

Marketing costs generally lead revenue, but must be controlled as a percentage to revenue and treated as a variable expense. It is a tremendous advantage when a business can truly treat its advertising costs as a variable, revenue-producing expense. It is critical to measure the results of various marketing methods. Tested, proven marketing strategies will enable you to develop a marketing plan that will generate a known dollar amount of revenue for every lead development dollar you spend.

Win at Biz Scorecard

Analyze your business and get creative. How many fixed expenses can you switch over to a percentage of revenue as variable expenses?

Reduce Fixed Expenses

When it comes to fixed costs you have to get tough and reduce costs wherever you can. That said, fixed expenses can be the most difficult to cut.

One of the masters at driving every penny out of fixed costs was John D. Rockefeller. In the book *Titan*, by Ron Chernow, we see the mind of a man who, by the age of 31, was the largest kerosene refiner in the world. During a routine inspection Rockefeller asked a welder, who was welding covers on the barrels of kerosene, have you ever tried putting fewer welds on the cover? The welder replied no. Rockefeller told him to experiment with the fewest number of welds that would seal the barrel. The result of the experiment was a reduction of three welds to the cover, standardizing the number of welds applied to every barrel and resulting in over $200,000 going to the bottom line. Ultimately, Rockefeller monopolized the kerosene refinery market by driving his costs so low that literally no one could compete with him.

You must be of the same mind. Be a tough negotiator. When you are negotiating new leases that affect occupancy costs, pay attention to your numbers. When hiring, do employ quality people, but pay attention to your breakeven number when establishing salaries, and insist that the employees earn their wage increases with bottom line performance. Don't give the farm away with employee benefits—they can add up in a hurry. Consider using temporary workers rather than full-time employees to handle peak periods of business. Research the benefits of outsourcing specific work functions that can be done more cost effectively by outside specialty companies. Investigate investments in new technology as yet another answer to reducing fixed expenses.

To manage an efficient bottom line company you must never stop working to lower your fixed expenses. Jack Stack, in his book *The Great Game of Business,* talks about the importance of becoming the lowest cost producer in any industry. Like Rockefeller, to survive long-term and operate profitably, you must beat the competition in delivering an unprecedented value to your customer. In order to do so, you have to develop a standard cost system for each of your departments based on your current profit and loss statement.

First, look at your current profit number and write down what it needs to be. Next, based on your current sales history, look at where your selling price points need to be relative to the competition and customer acceptance, and adjust your revenue number accordingly. Finally, discard your actual expenses and develop a standard cost system for each department based on where the numbers must be with the revenue and profit number you have just plugged in.

Tell your people that they must operate within these standard cost systems in order for the company to exist and provide jobs. This is managing by the numbers. It is tough, but leading a profitable business requires tough decisions and decisive action. Do not drag your feet in this critical area of financial management; the decisions and corrective actions will only get tougher the longer you wait.

Win at Biz Scorecard

- **Are you looking at your numbers and determining where costs need to be?**
- **Are you searching for creative ideas to lower your fixed costs?**
- **Are you making the tough decisions and putting those decisions into action?**

Improve Cash Flow

Remember, managing the operating profit on your income statement will not necessarily help your cash flow. To increase your cash flow, you must also improve the asset and liability accounts on your balance sheet. The balance sheet accounts are affected by the operating activities on your income statement.

For example, as sales increase on your income statement, your accounts receivable number may be increasing on your balance sheet. Even though increased revenue may be increasing your operating profit, *cash still may be decreasing* while accounts receivable are increasing. Be diligent in managing collections. See the section, “Know How Changing Your Operating Activities Affects Cash” for more detail. Suffice to say here, consider implementing the following changes to ensure that your increase not only your profits, but also your cash:

- Reduce your receivables to generate cash by accelerating payments from your customers from 30 days to 10 or 15 days.
- Step up the pressure to collect your past due receivables by calling them every 10 to 15 days and obtaining specific payment commitments.
- Hire a collection agency to collect accounts over 90 days past due.
- Tighten up your credit requirements to reduce future bad debt exposure.
- Increase the amount of payment due at the time of sale.
- Mail invoices the same day or next day to accelerate payment.
- Only accept your best accounts for credit and transact the rest on credit cards.

As sales increase, inventory will increase, thus diminishing cash flow. Reduce inventory by selling off slow movers—you’ll turn dead inventory into cash. Work with your suppliers to accelerate the frequency of shipments, thereby reducing daily inventory levels and improve inventory turnover ratios. Better yet, search for suppliers who inventory and ship within 24 hours.

As sales increase, accounts payable will undoubtedly increase, too. Extending payment terms with suppliers from 30 days to 60 or even 90 days will improve cash flow.

Plan Investment Activities and Capital Expenditures

The budget planning process is a good time to plan your investments. Increasing accounts receivable, expanding inventories, and paying growing accounts payable on time will all create a need for more cash.

Meet with your lending institutions regarding your forecasted cash needs, using your budgeting statements as backup. It is also a good time to make decisions regarding investments of cash into the business by owners. Discussions may also take place regarding the use of surplus cash to pay down debt or make dividend distributions to owners.

You should also plan for your capital expenditures during the budgeting process, including the replacement of aging fixed assets. (Remember that the depreciation expense on your income statement is not an actual cash outlay.) Investments in new fixed assets will affect cash in the form of outright purchase, finance payments, or lease payments. Examine how these investments are going to generate a return and what the return will be relative to the cost of money; you might consider used equipment rather than purchasing new.

Win at Biz Scorecard

In order to increase cash you will need a budgeted financial plan that will affect your operating income, balance sheet accounts, investment, and financing decisions.

- **Do you have a budgeted plan for the future?**
- **Do you have a list of actions to implement to get you where you want to go?**

Managing Cash

Your income statement, the asset and liability accounts on your balance sheet, and the cash flow statement are all inter-related. You cannot increase cash flow without managing the operating activities from your income statement and the financial accounts of your balance sheet. Remember, the income statement does not tell you how much cash is coming into the business from sales or going out of the business from expenses. A bottom line profit from operating activities on your income statement does not mean the company is accumulating cash in the bank.

How to Get a Bank Involved

Cash can be affected by the decisions you make about your finance activities with lending institutions and owner investments or distributions. Your finance activities will affect cash whenever you are raising capital from debt or using cash to reduce existing debt. It is a good idea to establish credit as soon as possible with a lending institution to cover periods of time when the company experiences shortages in cash flow. Short-term demand notes, generally one year in duration, will allow you to draw against the note whenever you need cash to pay your bills on time. It is important to have a reliable source of cash so you can pay your suppliers on time, and take advantage of any discounts they might offer for prompt payments. During periods of positive cash flow, you can pay the demand note down.

To establish short-term demand notes with a lender will require a personal guarantee, a good personal credit history, a pledge of assets of the business as collateral for the loan, and good ratios on your balance sheet. Typically you must pledge your inventory and accounts receivable. A bank will generally loan up to 50 percent of inventory at cost and 75 percent of current (60 days or less) accounts receivable.

Many new business owners tend to ignore the ratios on their balance sheet. Don't make the same mistake by falling asleep in this area of financial analysis. You can be assured that when you visit a lending institution for financing, the bank will scrutinize your financials. It will compare your current numbers to a trend of numbers of the same financial category from the previous five years. It will compare trends in expenses to see how successful you are at managing costs to maximize your bottom line. The same will be true for analyzing your success at managing costs that affect gross margins. Your banker will also analyze the five-year trends of asset and liability accounts on your balance sheet. For example, he or she will look at the number of days it takes to turn over your accounts receivable and inventory, how effective you are at maximizing cash, and how effective you are at managing your working capital to ensure that there is enough cash to cover accounts payable and short-term debt.

The banker will also look at the relationship of fixed assets to long-term debt. The ratios banks generally look at will be your current ratio, acid test (or quick ratio), debt-to-equity ratio, and working capital to sales. A cash flow statement will be compiled to determine both the company's net cash flow and how cash is being used and distributed. If you are a new business and the company cannot demonstrate a track record of successful financial management, do not be surprised when the lending institution asks you to pledge the equity you have in your home or other personal assets to secure the loan.

Once you are doing business with a lending institution, it is very important to keep the banker apprised of what is going on with changes in your business and changes with the numbers on your financial statements. Treat the bank as the partner it is in your business.

Win at Biz Scorecard

There is nothing more important than maintaining a solid reputation with your lending institution.

How to Pay Yourself

Owners can become either a source of cash or a use of cash. A common pitfall for small businesses owners is to take too much cash out of the business for their own personal consumption. When making these decisions, you will want to consider the financial strength, growth potential, and the effects on your balance sheet.

For example, company Beta has $500,000 in cash at the end of their fiscal year. The balance sheet shows $1,000,000 in debt and total equity of $200,000. If the owners decide to distribute the entire $500,000 in cash to themselves as dividend withdrawals, the debt to equity remains a terrible 5:1. On the other hand, if the owners distribute only $200,000 of the cash in dividends to themselves and retain $300,000 in retained earnings, the total equity will be increased to $500,000. The debt to equity ratio will be improved to an acceptable 2:1. Of course, another option would be to use all of the cash to reduce debt by $500,000, which would improve the debt to equity ratio to 2.5:1; additionally this will reduce interest expense and increase cash flow going forward.

When you are making decisions about dividend withdrawals, pay attention to the balance sheet ratios, pay yourself a reasonable salary (typically no more than 5 percent of revenue), and live within your financial means.

Win at Biz Scorecard

Do not be the financial ruin of your company! Make responsible decisions regarding utilizing cash to pay down debt and distributing owner dividends. Never take a larger personal salary than what the company can afford to pay.

How to Invest in Your Equipment

Many businesses need tangible assets such as trucks, manufacturing equipment, computers, and other long-lived equipment to operate their business. For example, how could a printing business produce a product without investing in printing equipment? Your capital expenditures—what you decide to spend money on—will reduce cash in the form of purchases, lease or financing payments. However, the act of acquiring long-term fixed debt for financing fixed assets will increase cash (to pay for the fixed asset.) You will also increase cash when you dispose of your used fixed assets.

Ratios can help you make decisions about how to choose and finance big purchases with new long-term fixed debt. For example, what is the current return company Alpha is receiving on net operating assets? If Alpha's income statement shows $50,000 in operating profit and you divide that by $1,000,000 in net operating assets (total assets less non-interest-bearing liabilities) you get a 5 percent return on net operating assets. Does it make sense to pay 7 percent for additional long-term debt to finance more equipment when the company is only getting a 5 percent return? On the other hand, the company could be attempting to improve the return by investing in replacement equipment that is more efficient and productive.

Whatever your strategy, you must pay attention to the effect your decisions will have on cash flow.

Win at Biz Scorecard

Before you invest in new equipment, figure out how the equipment is going to give you a return on your investment, how it will affect cash, and how it will affect operating income.

How Changing Your Operating Activities Affects Your Cash

Companies make decisions and take actions every day to improve their operating income on their income statement. But how do your day-to-day decisions affect cash balances?

To increase your operating income, you need to make changes that increase sales and reduce expenses relative to sales. As operating activities occur, any changes in your sales and various expense accounts will affect the asset and liability accounts on your balance sheet. Those changes on your balance sheet will determine your cash balance. The relationships are complex and nuanced, but have patience! Learn the basics here, and you will see how important this subject is for every business owner to absorb.

The following are some of the most common, cash-relevant relationships between operating activities that may affect your income statement and the various asset and liability accounts of your balance sheet.

The Relationship Between Sales, Accounts Receivable, and Cash

Many businesses extend credit to their customers when a sale is made. Rather than new sales increasing cash, they increase an asset account named *accounts receivable.* Accounts receivable on the balance sheet represents sales waiting to be converted to cash. Consider a company, “Kappa,” that increases sales from $2,000,000 to $2,700,000. The increase in sales can increase or decrease cash depending on what is happening with accounts receivable. Company Kappa saw their accounts receivable increase from $250,000 at the beginning of the year to $320,000 at year’s end. The $70,000 increase in accounts receivable will decrease Kappa’s cash by the same amount.

The Relationship Between Sales, Inventory, and Cash

Many businesses sell a product to generate sales. A business of this nature needs to have product on hand waiting to be sold. This product does not become a “cost of goods sold” expense until the product is actually sold. In the meantime, the product that has been purchased increases an account named “inventory.”

Inventory on the balance sheet represents an asset waiting to be converted to sales and ultimately to cash. Consider a company, “Gamma” who increased sales from $4,000,000 to $7,000,000. Gamma’s gross profit margin last year was 48 percent, which means their cost of goods sold was 52 percent. Gamma turns their inventory ten times per year, which means they needed to keep $208,000 of inventory on hand ($4,000,000 x 52 percent = $2,080,000 cost of goods sold divided by 10 = $208,000). This year Gamma sold $7,000,000 at a 50 percent gross profit margin with an inventory turnover ratio of 10. The increase in sales would require Gamma to keep $350,000 of inventory on hand. The $142,000 increase in inventory would reduce cash by the same amount.

The Relationship Between the Asset Account, Prepaid Expenses, and Cash

Many businesses will elect to prepay some expenses. For example, insurance is an expense that is often prepaid for a six or twelve month period. Many times a company does not want to expense the insurance all at once, but rather allocates the cost over a period of time and actually expenses the cost to the income statement during the month that it is benefiting the company. In such instances, when the insurance is paid for in advance, it will increase an asset account named *prepaid expenses* and reduce cash. Prepaid expenses on the balance sheet represent an asset waiting to be converted to an expense.

The Relationship Between Depreciation Expense, Fixed Assets, and Cash

Many businesses purchase fixed assets such as real estate, manufacturing equipment, trucks, and office equipment. At the time these fixed assets are purchased, cash is reduced or long-term debt is increased to finance the purchase. The main point to understand is that the fixed asset has a limited useful life and will eventually need to be replaced. In order to recover the cost of the fixed asset through sales, a portion of the asset’s original cost must be expensed every year to an expense account named “depreciation expense.” The depreciation expense account has no direct affect on cash flow; however, it does serve the purpose of reserving cash from revenue for replacement of the fixed asset when its useful life expires.

For example, a company, “Kappa,” purchases a fleet of delivery trucks for $250,000. For simplification, we will assume Kappa paid cash for the vehicles, thus increasing fixed assets by $250,000 and reducing cash by the same amount of $250,000. We will also assume a useful life of five years for the trucks. Each year, for five years, Kappa would expense $50,000 to the depreciation expense account. (Making an accounting entry to the depreciation expense account does not affect cash.) The offsetting $50,000 entry is posted every year to accumulated depreciation (i.e., credited to an asset account) which will write the value of the fixed asset down to zero in five years. In order for Kappa to show an operating profit, products must be priced high enough so that revenue covers the $50,000 in the depreciation expense account plus have enough left over for an operating profit. By making an accounting entry to the depreciation expense account every year and assuming the company is breaking even, Kappa will be accumulating $50,000 in cash each year for the replacement of the retired asset at the end of the five years. See the accounting entries below.

Example 4: Accounting Entries

Purchase of the Asset:

Credit to Cash... ($250,000)	Debit to Fixed Asset... $250,000

First Year Expense Entry:

Debit to Depreciation Expense... $50,000	Trucks... $250,000 Credit to Accumulated Depreciation... ($50,000) Total Fixed Assets... $200,000

The Relationship Between Expenses Not Paid, Accounts Payable, and Cash

Most companies buy items and services on credit that are expenses to the company. When invoices are received for payment at some future date, they are entered to an expense account on your income statement that will accurately reflect the month the expense was incurred. And offsetting entry is entered to an account named "accounts payable."

This accounting entry has no effect on cash. When the invoice is actually paid, both cash and accounts payable are reduced. There may be additional accounts payable accounts for specific expenses not yet paid, too—some examples include sales tax payable, federal and state withholding taxes payable, and income taxes payable.

Statement of Change

Example 5 is a statement of change that illustrates the interrelationship of the operating activities, investing activities, and financing activities with the beginning and ending balances on the balance sheet. The entry "($000)" indicates credit accounts and credit entries.

Notice that even though operating activities increased cash by $55,000, cash decreased for the period due to investing decisions made to purchase fixed assets for $20,000, finance decisions made to reduce debt by $40,000, and dividends distributed to owners for $70,000.

Example 5: Statement of Change

Beginning	Operating Balances	Operating Activities	Financing Balances	Balances	Operating Activities
Cash	$250,000	$55,000	($20,000)	($110,000)	$175,000
Accounts Receivable	$450,000	($30,000)			$420,000
Inventory	$550,000	$50,000			$600,000
Pre-paid Expenses	$15,000	$4,000			$19,000
Fixed Assets (net)	$150,000	($35,000)	$20,000		$135,000
Total Assets	$1,475,000	$44,000		($110,000)	$1,409,000
Accounts Payable	($150,000)	($25,000)			($175,000)
Interest Bearing Debt	($400,000)			$40,000	($360,000)
Owner Invested Capital	($200,000)				($200,000)
Owner Dividends	$150,000			$70,000	$220,000
Retained Earnings	($875,000)	($19,000)			($894,000)
Total Liabilities & Equity	($1,475,000)	($44,000)		$110,000	($1,409,000)

Win at Biz Scorecard

To effectively manage your cash, you must manage the activities of both your income statement and your asset and liability accounts.

Periodic Health Assessments

In order to be successful at achieving your budgeted financial goals, it will be necessary to conduct periodic (weekly, monthly, and quarterly) financial health assessments. Think of your financial assessment as a diagnostic gap analysis where you measure the distance between your budgeted goals and the actual financial results. Look for early warning signs of problems in your cash flow, working capital, turnover of your inventory and accounts receivable, revenue, gross profit margins, and expenses. Create a daily matrix of numbers to spot-check your progress. Develop new action lists of corrective steps to close the gap between your current situation and your budgeted financial goals. To be successful at financial management requires constant re-assessment and corrective action.

Win at Biz Scorecard

Are you continually re-assessing the difference between your actual financial results and your budgeted goals?

Win at Biz Checklist

✔ Do you have accurately prepared income statement, balance sheet and cash flow statements prepared for your review every month?	☐ Yes	☐ No
✔ Do you develop internal profit reports to help you focus on your profit centers and what is driving profit?	☐ Yes	☐ No
✔ Have you developed internal budgets for your income statement and balance sheet accounts and forecast how those budget decisions affect cash flow?	☐ Yes	☐ No
✔ Have you developed a written plan of actions to get you from your current financials to where you want to go in your budgeted plans?	☐ Yes	☐ No
✔ Do you have a plan of actions to positively impact revenue?	☐ Yes	☐ No
✔ Do you have a plan of actions to lower your breakeven point?	☐ Yes	☐ No
✔ Do you have a plan of actions to reduce fixed costs?	☐ Yes	☐ No
✔ Do you have a plan of actions to improve your margins?	☐ Yes	☐ No
✔ Do you have a list of actions to improve the management of accounts receivable, inventory and accounts payable that will improve cash flow?	☐ Yes	☐ No
✔ Have you managed your cash for the replacement of fixed assets?	☐ Yes	☐ No
✔ Do you research the return on investment before making decisions on purchasing new fixed assets?	☐ Yes	☐ No
✔ Do you, as an owner, take reasonable annual salary relative to the profits generated, leaving an appropriate amount of annual profits in the company as retained earnings?	☐ Yes	☐ No
✔ Do you maintain an excellent working relationship with your bank?	☐ Yes	☐ No
✔ Do you keep them informed about changes in your operating financials and your budgeted plans?	☐ Yes	☐ No
✔ Do you conduct routine finanical health checks to monitor the difference between your budgeted goals and current results?	☐ Yes	☐ No
✔ Do you educate your employees regarding how their actions affect the numbers?	☐ Yes	☐ No
✔ Have you assembled a board of advisors with whom you may consult about your company’s financials?	☐ Yes	☐ No

APPENDIX TO CHAPTER ONE

If you are unfamiliar with basic financial statements, we will start at the very beginning. The three most important financial forms you will use will be the balance sheet (Exhibit A) the income statement (Exhibit B) and the cash flow statement (Exhibits C and D). Common financial ratios also serve as valuable management tools and are reviewed here. You will find all financial exhibits in this appendix.

The Balance Sheet

The balance sheet in Exhibit A tells you what the company is worth on any given day by deducting all the liabilities from the total of all the assets. Frequently used financial terms in the balance sheet include the following.

Assets. Anything that the company owns that has monetary value.

Current Assets. Assets such as cash, accounts receivable, and inventory that can be converted to cash during the normal course of business.

Cash. Money that is immediately available.

Accounts Receivable. Monetary obligations due to the company.

Fixed Assets. Assets that cannot be quickly turned into cash. Fixed assets would include real estate and long-lived productive assets such as equipment.

Liabilities. Any debt obligations of the company.

Current Liabilities. Liabilities such as accounts payable, payroll taxes, and short-term bank notes that are due during the normal course of business within one year.

Accounts Payable. Outstanding invoices or bills due to others.

Long-term Liabilities. Longer term debt obligations such as real estate mortgages or financing on equipment or store fixtures that are due over a period of time longer than one year.

Equity. Represents the ownership of the company.

Total Equity. The net worth or value of the company after deducting the liabilities from the assets.

Exhibit A
Balance Sheet
December 31, 2008

Assets

Current Assets	
Cash	$100,000
Accounts Receivable	$200,000
Inventory	$500,000
Total Current Assets	$800,000
Fixed Assets	
Fixtures & Equipment	$300,000
Accumulated Depreciation	($100,000)
Total Fixed Assets	$200,000
Total Assets	1,000,0000

Liabilities & Equity

Current Liabilities	
Accounts Payable	$250,000
Demand Bank Note	$300,000
Federal Payroll Taxes	$26,000
State Payroll Taxes	$8,000
Sales Tax Payable	$15,000
Total Current Liabilities	$599,000
Long-Term Liabilities	
Bank Equipment Financing	$100,000
Total Long-Term Liabilities	$100,000
Total Liabilities	$699,000
Equity	
Issued Capital Stock	$1,000
Retained Earnings	$250,000
Profit or (loss) YTD	$50,000
Total Equity	$301,000
	$1,000,000

The Income Statement

The income statement (or the profit and loss statement) in Exhibit B tells you if the company is making a profit after all expenses are deducted. The income statement does not give you information about its cash position or the company's net worth. Frequently used financial terms in the income statement include the following.

Sales. The income (or sales) tells you what you have sold in product or services.

Cost of Goods Sold. The cost of goods sold reflects your cost of the product that has been sold plus any related freight costs.

Gross Profit. The gross profit is computed by subtracting cost of goods sold from income or sales. It is often referred to as the gross profit margin, which represents the percentage of profit from each sale before deducting operating expenses.

Operating Expenses. Operating expenses consist of both direct expenses (or variable expenses) and general and administrative expenses (or fixed expenses). Direct expenses are expenses that are incurred only when income is generated from sales; they are not incurred unless there is a sale. For example, if your salespeople are paid a straight commission on sales, your sales expense will always vary as a direct percentage to total sales. The higher the sales become, the higher the commission expense; conversely, the lower the sales become, the lower the commission expense. Direct expenses are easy to forecast because they will always be a specific percentage of sales.

General and Administrative Expenses (or Fixed Expenses). Expenses that are fixed and do not vary with the amount of sales. Examples of fixed expenses would be rent, utilities, insurance, and administrative salaries.

Net Profit. The net profit before taxes would be determined by subtracting the operating expenses, or both the direct expenses and the general and administrative expenses, from the gross profit.

Exhibit B

Income Statement

	December 31, 2008		December 31, 2007	
INCOME				
Sales	$1,000,000		$1,200,000	
Total Sales	$1,000,000		$1,200,000	
COST OF GOODS SOLD				
Cost of Goods Sold	$500,000	50%	$645,000	53.75%
Freight	$50,000	5%	$75,000	6.25%
Total Cost of Goods Sold	$550,000		$720,000	
GROSS PROFIT MARGIN	$450,000	45%	$480,000	40%
OPERATING EXPENSES				
Rent	$50,000	5%	$50,000	4.2%
Telephone	$3,000	0.3%	$2,500	0.21%
Electrical	$9,000	0.9%	$8,500	0.71%
Advertising	$50,000	5%	$55,000	4.58%
401K Expense	$6,000	0.6%	$7,000	0.6%
Health Insurance	$20,000	2%	$25,000	2.1%
Liability Insurance	$5,000	0.5%	$4,000	0.3%
Workman's Comp Insurance	$5,000	0.5%	$4,500	0.4%
Unemployment Taxes	$2,000	0.2%	$1,500	0.1%
Employer FICA	$14,000	1.4%	$15,000	1.2%
Office Payroll	$75,000	7.5%	$70,000	5.8%
Sales Payroll	$75,000	7.5%	$85,000	7.1%
Other Payroll	$50,000	5%	$55,000	4.6%
Legal & Accounting	$1,000	0.1%	$1,000	0.8%
Interest Expense	$30,000	3%	$27,000	2.3%
Supplies	$1,000	0.1%	$1,500	0.1%
Postage	$1,000	0.1%	$1,200	0.1%
Technical Support	$1,000	0.1%	$1,500	0.1%
Bank Fees	$1,000	0.1%	$1,200	0.1%
Total Operating Expenses	$400,000	40%	$416,400	34.7%
NET PROFIT	$50,000	5%	$63,600	5.3%

The Cash Flow Statements

The cash flow statements in Exhibits C and D tell you if the company has enough cash in the bank to pay the bills. This is a flow statement that paints you a picture of the money that is flowing into and out of the company. The balance sheet can tell you if you have less cash in the bank at the end of an accounting period but does not indicate how the money was used.

Your income statement will tell you if the operation of the business lost money, however, the income statement will not give you the details of cash flowing into and out of the company. Perhaps the company used cash to pay down debt or made a large investment in equipment; possibly sales on credit terms are increasing while accounts receivable collections are lagging, creating a decrease in cash.

You must manage both the profit and the financials of your balance sheet to manage cash flow; you cannot manage one and not the other. The cash flow statement is divided into three main categories using the financial terms below.

Cash Flows from Operating Activities. This section of the statement shows you sources of cash flow from the profit generating operations of the business only. Other sources of cash are excluded. The operating section of the cash flow statement can be reported in two methods.

The *direct method* of reporting operating activities illustrated in Exhibit C shows how the operating cash flows are directly related to sales and expenses.

Exhibit D focuses on showing how operating cash flows from sales and expenses have changed the connected asset and liability accounts. This reporting method is known as the *indirect method*. A company experiencing strong sales can experience an increase in accounts receivable and inventory. The indirect method of reporting operating activities will show these asset categories increasing while cash is decreasing. Likewise, accounts payable, a liability category, may be increasing which would have a positive effect on building cash.

The final net cash flow number from operating activities will be the same with both reporting methods.

Cash Flows from Investing Activities. Many companies are required to make capital expenditures in long-term tangible assets in order to operate their businesses; examples could include real estate, trucks, or equipment. The expenditure will decrease cash while the salvage value from selling the equipment will increase cash.

Cash Flows from Financing Activities. This section of the statement provides information about cash flows from both debt and equity sources. Cash can be decreased by owner dividend distributions or by paying down debt; it can be increased by owners investing additional funds into the business or by raising capital from a lending institution.

Exhibit C

Direct Method Cash Flow Statement

Cash Flow from Operating Activity

Net Income	$1,000,000
Cost of Goods Sold	($600,000)
Operating Expenses	($300,000)
Interest Expense	($25,000)
Net Cash Provided by Operating Activities	$75,000

Cash Flow from Investing Activities

Fixed Asset Purchases/Salvage	($25,000)
Net Cash Provided by Investing Activities	($25,000)

Cash Flow from Financing Activities

Short Term Bank Note	($15,000)
Long Term Bank Financing	$25,000
Dividend Dispersements	($35,000)
Net Cash Provided by Financing Activities	($25,000)

Net Cash Increase/Decrease for period	$25,000
Cash at Beginning of Period	$10,000
Cash at End of Period	$35,000

Exhibit D

Indirect Method Cash Flow Statement

Cash Flow from Operating Activity	
Net Income	$95,000
Adjustments to Reconcile Net Income to Net Cash Provided by Operations:	
Accounts Receivable	($45,000)
Inventory	$25,000
Depreciation Expense	($35,000)
Accounts Payable	$10,000
Net Cash Provided by Operating Activities	$50,000
Cash Flow from Investing Activities	
Fixed Asset Purchases/Salvage	($15,000)
Net Cash Provided by Investing Activities	($15,000)
Cash Flow from Financing Activities	
Short Term Bank Note	$25,000
Long Term Bank Financing	$15,000
Dividend Dispersements	($50,000)
Net Cash Provided by Financing Activities	($10,000)
Net Cash Increase/Decrease for period	$25,000
Cash at Beginning of Period	$15,000
Cash at End of Period	$40,000

Common Financial Ratios as Tools

One way to interpret financial performance is with the computation of ratios. Ratios will not provide answers; however, they are helpful indicators when comparing current performance to past performance or when comparing to industry standards. For example, the industry averages for gross profit margins for retail furniture stores may be published to be 46 percent, average sales per square foot to be $185 per square foot, an inventory turn-over ratio of 3.5, advertising as a percentage to sales at 7 percent and a net operating profit of 5 percent. When you know what the average performance is of the competitors within your industry, you have a yardstick against which to measure your own performance. The following are some commonly used ratios.

Common Size Ratio. This is a ratio that expresses the percentage of a line item to the total and is commonly used on the income statement (see Exhibit B). Common size ratios are useful in evaluating your line item percentages to industry averages or comparing your line item percentages from the current quarter to last quarter or current year to previous years.

Current Ratio. This ratio expresses, as a number, a comparison of the current assets to the current liabilities. For example, in Exhibit A the total current assets are $800,000 and the total current liabilities are $599,000 or a current ratio of 1.33. Lenders like to see a current ratio of 2. You compute the current ratio by dividing the current assets by the current liabilities. The current ratio indicates the financial strength of the company. The higher the current ratio is, the stronger the company's ability to meet its short-term financial obligations.

Acid Test. Also known as the *quick ratio,* this is another way to test the company's ability to pay its short-term financial obligations without liquidating inventory. The acid test of liquidity is a more serious test than the current ratio because it excludes inventory and pre-paid expenses from current assets. To compute the acid test, take the total of the cash and the accounts receivable from the current assets in Exhibit A (any short-term marketable securities would also be included), which equals $300,000 of quick assets. Divide the quick assets by the current liabilities of $599,000. Using the balance sheet in Exhibit A the quick ratio would be 0.5. Lenders prefer the ratio to be 1 or greater. A ratio of 0.5 or lower is cause for alarm because your liquid assets are not large enough to meet your current debt obligations. Inventory is not considered a reliable liquid asset because there is usually a cost associated with turning inventory to cash.

Working Capital to Sales Percentage. This ratio compares your working capital (current assets minus current liabilities) as a percentage to your sales. For example, the working capital of $201,000 (in Exhibit A, current assets of $800,000 minus current liabilities of $599,000 equals working capital of 201,000) is divided by sales in Exhibit B of 1,000,000, which equals 20 percent. The working capital is expressed as a percentage to sales, or 20 percent. The higher the actual working capital is relative to a constant revenue number, the higher the working capital will be as a percentage of sales. A higher working capital to sales percentage indicates a stronger cash flow and an improved ability to pay bills on time. Positive working capital is a part of operating capital that ensures your company is able to continue its operations and that it has sufficient funds to satisfy both maturing short-term debt and upcoming operational expenses. The management of your working capital involves managing inventories, accounts receivable, payables, and cash. Managing cash relative to these asset and liability accounts will be discussed in the upcoming pages.

Debt-to-Equity Ratio. This ratio expresses the total debt (including both current and long-term liabilities) to the total equity. This ratio tells a lender the company's capacity to borrow additional funds based on the ratio that tells how much money the company owes others versus the value of the owner's equity. For example, in Exhibit A, the total liabilities is 699,000 and the total equity is 301,000, yielding a debt-to-equity ratio of 2.3:1. You compute the debt-to-equity ratio by dividing the total liabilities by the total equity. Banks prefer a debt to equity ratio of 2:1. A higher ratio, for example, of 3:1 or 4:1 tells the lender that the company has more debt relative to owner equity. The higher the debt is relative to equity, the greater the perception of financial risk.

Inventory Turnover Ratio. This ratio compares your annual cost of goods sold (or inventory sold) to your total inventory on hand at cost (including freight). For example, in Exhibit B you would take your total cost of goods sold for the year, or $550,000, and divide that by your total inventory from Exhibit A (including freight), or $500,000, which equals 1.1. That number tells you how many times you turn your inventory per year. You should compare this number to industry averages. The higher the number, the better you are using the cash invested in inventory to generate sales. A higher number also tells you the salability of your inventory in a competitive market place.

Sales per Square Foot. This is a number most commonly used by retail stores that simply tells you what your sales are per square foot. For example, divide annual sales in Exhibit B, which is $1,000,000, by the total square footage of sales area. If your square footage is 10,000 square feet, you would be selling $100 of sales per square foot. Your sales per square foot number can be compared to industry averages. The higher the number, the better you are utilizing your investment in your real estate and your inventory to generate sales. A higher sales per square foot number tells you how well you are doing regarding a host of management actions that positively or negatively affects sales.

Fixed Asset Ratio. The fixed asset ratio shows the productivity of a company by examining the amount of sales that are generated from the company's investment in fixed assets (e.g., plant and equipment). To compute the fixed asset ratio divide sales by the fixed assets. Utilizing the numbers in Exhibits A and B, the ratio would be 5:1. When you consider the capital expenditures required for fixed assets in different industries, you can quickly realize this ratio can vary widely from industry to industry. It is important to do comparisons within industry standards.

Profit Ratio. The profit ratio tells you the percentage of profit for every dollar of sales after deducting all of the expenses. In Exhibit B the profit percentage is 5 percent, which is computed by dividing the $50,000 net profit by the sales of $1,000,000. Profit margins can vary widely from industry to industry; however, 5 to 10 percent is common.

Gross Profit Margin. Gross profit margin is the dollars you make on every sale after deducting the cost of goods sold. Calculate the gross profit margin by dividing the gross profit (sales less cost of goods sold) by the sales. In Exhibit B, divide $450,000 in gross profit by $1,000,000 in sales equals a 45 percent gross profit margin. The gross profit margin must be large enough to pay all of the expenses and have enough left to generate a profit. Compare your gross margins to industry standards. Never underestimate the impact of a change to your gross profit margin. Every change, no matter how small, goes directly down to the bottom line.

Return on Assets. The return on assets ratio will tell you how productive your assets are in producing a profit. To compute the return on assets, divide the operating profit (before interest income and income tax expense) by the net operating assets (total assets minus non-interest-bearing liabilities). Compare your return to the interest rates you are paying on debt. If your ROA is 12 percent and you are paying 7 percent for borrowed funds, the company is making a net gain of 5 percent on its borrowed capital. Companies with an ROA less than the interest rate on their debt are not generating enough operating profits to validate the debt incurred to finance the profit-generating assets. These companies need to examine the productivity at every level of their businesses.

Return on Equity. The return on equity ratio is the amount of net profit or income you are generating from the owners total equity. To compute the return on equity, divide the net income by the total equity. In Exhibit B divide the net income of $50,000 by the total equity of $301,000 in Exhibit A to give you a 16.6 percent return on equity. Compare your return on equity to beating average annual returns on common stocks and government bonds.

About the Author

David Gabbert

Entrepreneur, business mentor and growth coach, David Gabbert helps business professionals, business owners, new startups, and students learn how to win at business. Self employed for forty-seven years, founder and owner of four million-dollar-plus businesses, and author of ten Win at Biz® business books, Dave offers free business articles about a variety of proven business strategies which compose the basic building blocks of starting and operating a successful business.

Free monthly e-zine subscriptions are available: www.davidgabbertbusinesscoach.com

We welcome your comments and questions: david@winatbiznow.com

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