

Best Practices for the BottomLine

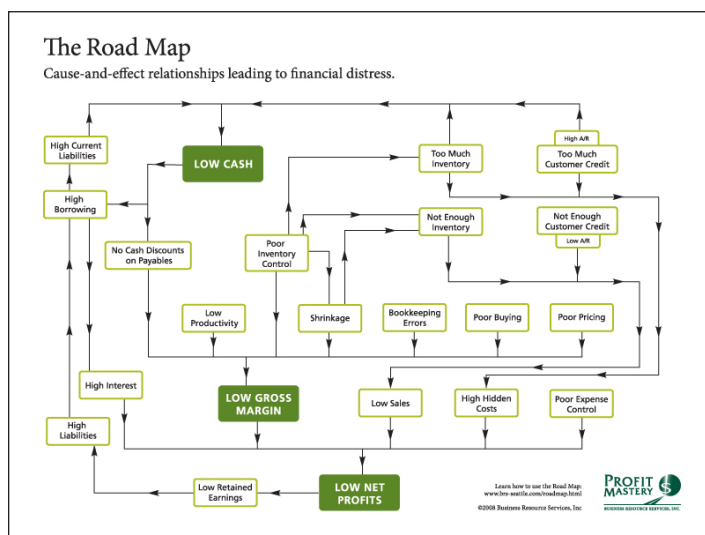
The Profit Mastery Assessment: Quantifying the Effect of Management Changes.

In our work with business owners, we strongly encourage them to seek professional support in those areas of their business where they are not the experts. Typically, we suggest that they should have a team that consists of an attorney, a banker, and an accountant to provide specialized knowledge in their respective fields.

Often, the business owner volunteers that he has a CPA and makes a statement like this: “Of course I work with a CPA. You wouldn’t expect me to do my taxes myself, would you?” Unfortunately, many business owners view their CPA as merely the “tax man.” Equally as unfortunate, many CPAs reinforce this narrow view of the services they can provide by settling for doing taxes. We believe that the accounting profession has many skills that can be incredibly useful to business owners as they go through their business life cycle: start up, through growth, through transition. In this article, we’ll provide one way in which you can support your business clients while increasing the consultative side of your business.

We believe that it’s helpful to use healthcare as an analogy here. If someone comes to a physician with a troubling symptom, let’s say back pain, any physician worth his or her salt is going to try to understand what’s causing the pain before offering up a treatment. Maybe an x-ray or an MRI. Certainly a physical examination. In the same way, when a business owner experiences one of the three most common symptoms of financial distress — low cash, low profits, low gross margin — in his or her business, it’s critical to understand what’s causing the symptom. Taking low cash as an example, the knee-jerk response may be to borrow more money to get through the crisis. This is akin to a physician prescribing ibuprofen for back pain without exploring what’s causing the pain.

View the “Road Map” below to better understand the interconnecting relationships that make up the financial functioning of a business. To understand the nature of the relationships diagrammed here, when following in the direction of the arrows, insert the word “causes.” In other words, “low cash causes high borrowing.” When going against the arrows, insert the words “is caused by.” As an example, “low net profit is caused by high hidden costs.”



In this way, we can use the Road Map to begin to explore and diagnose what may be creating the symptom of financial distress. Back pain can be caused by a herniated disc, a muscle strain, a tumor, or any of a host of other problems. Without exploration, the physician doesn’t know which cause to treat. To extend the analogy, when someone comes to you with the financial symptom of low cash, the Road Map tells you that low cash can be caused by high current liabilities, by too much inventory, and/or by high A/R. But which to treat? That’s where exploration of your patient’s medical record — in this case the financial statements, for these are your diagnostic tools — will reveal which of the causes is creating the symptom.

It’s also remarkably informative to take a look at where a business has been. This is akin to a physician taking a detailed history on the patient. Using back pain again, you would want to



know if the patient has had back pain in the past, if he/she had engaged in some activity recently that may have precipitated the pain, if there's a family history of back problems, etc. In finance, we want to look at not only the current financial statements, but also at statements for at least the past three years. Has there been a trend which has only now reached a point where it creates financial distress? We believe that looking at important financial ratios, current, quick, debt-to-worth, gross and net margin, and others that fit for the type of business, can be most instructive. For more detail view the "Ratio Analysis Spreadsheet on page 3.

You'll notice that in addition to looking at three years financial data, there's a column labeled "Industry Composite." For most businesses, there are benchmarks that have been established for the financial operation of those businesses. In our medical model, how do you know if someone's white blood cell count is too high if you don't have a benchmark or a standard? For franchise organizations, many have benchmarked their networks. Many trade associations also conduct benchmarking activities for their members. For those who don't have access to information from these sources, Risk Management Associates publishes an extensive listing of benchmarks for specific business categories that is extremely helpful. These numbers, when compared with those that come from your client's financials, can be very instructive in determining where the business is "out of round" in comparison with similar businesses.

Armed with all of this information, you can benefit your client by quantifying the effect that certain changes can make to correct the distressing symptom. For instance, if a business carries receivables, an examination of history may reveal a trend that your client has been less diligent in getting payment from his clients for goods and services. A check of industry standards may show that his turnover time for collections is slower than the industry average. Therefore, in order to MANAGE this business, your client should be encouraged to streamline his/her collections procedures.

Unfortunately, many business owners will say, "I've only slid a few days" or "I'm only few days off the industry average." At this point, you can take them through an exercise that will put a

dollar value on their inefficiency and their laissez-faire attitude. As an example, let's assume that over the three years examined that their A/R collection period has slid by four days, from 36 to 40. This means that his A/R turns (the number of times his A/R turns over in the course of a year) are 9.1. Additionally, the industry benchmark is 33 days. That means that similar businesses are turning their receivables 10.9 times per year. That puts your client "out of round" by 1.8 turns. If his sales are \$1,077,000, that means his receivables should be about \$99,000 ($\$1,077,000/10.9$). His actual receivables are \$118,700. The amount that his lack of attention is costing him is \$19,700 ($\$118,700 - \$99,000$). This is money that is in his customers pockets instead of his bank account. Therefore, his own lack of management activity is creating a \$19,700 hole in his checkbook. Our guess is that this will be more meaningful than making a big deal of being seven days behind the industry average in collections.

Similar calculations can be performed for inventory, for hidden costs, or for any of the other cause-and-effect relationships demonstrated on the Road Map. We've developed a tool for itemizing how management efficiencies can impact the profitability and cash flow of a business. We call it the Profit Mastery Assessment. See Profit Mastery Assessment (PMA) Summery Report on page 4.

Taken as a whole, the activities of looking at history, utilizing industry comparatives and quantifying the effect of management changes can provide a struggling business owner with powerful information. When coupled with goal setting, the development of action plans, and a timetable for follow up, you have provided a service to your clients that they should be happy to pay for. By providing more than tax services to your client, you have helped him/her to put into place one of our mantras: What gets measured gets managed, and what gets managed gets done.

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Ratio Analysis Spreadsheet

	Year	Year	Year	Industry Composite	Calculations, Trends, or Observations
	_____	_____	_____		

BALANCE SHEET RATIOS: Stability (or “Staying Power”)

1.	Current	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$					
2.	Quick	$\frac{\text{Cash + Accts. Rec.}}{\text{Current Liabilities}}$					
3.	Debt-to-Worth	$\frac{\text{Total Liabilities}}{\text{Net Worth}}$					

INCOME STATEMENT RATIOS: Profitability (or “Earning Power”)

4.	Gross Margin	$\frac{\text{Gross Profit}}{\text{Sales}}$					
5.	Net Margin	$\frac{\text{Net Profit Before Tax}}{\text{Sales}}$					

ASSET MANAGEMENT RATIOS: Overall Efficiency Ratios

6.	Sales-to-Assets	$\frac{\text{Sales}}{\text{Total Assets}}$					
7.	Return on Assets	$\frac{\text{Net Profit Before Tax}}{\text{Total Assets}}$					
8.	Return on Investment	$\frac{\text{Net Profit Before Tax}}{\text{Net Worth}}$					

ASSET MANAGEMENT RATIOS: Working Capital Cycle Ratios

9.	Inventory Turnover	$\frac{\text{Cost of Goods Sold}}{\text{Inventory}}$					
10.	Inventory Turn-Days	$\frac{360}{\text{Inventory Turnover}}$					
11.	Accounts Receivable Turnover	$\frac{\text{Sales}}{\text{Accounts Receivable}}$					
12.	Accounts Receivable Turn-Days	$\frac{360}{\text{Accts. Rec. Turnover}}$					
13.	Accounts Payable Turnover	$\frac{\text{Cost of Goods Sold}}{\text{Accounts Payable}}$					
14.	Average Payment Period	$\frac{360}{\text{Accts. Pay. Turnover}}$					

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Profit Mastery Assessment (PMA) • Summery Report

	Cash	Profit
Inventory		
Hidden Costs & Interest		
A/R		
Hidden Costs & Interest		
Gross Margin		
Labor		
Buying		
Pricing		
Cash Discounts		
Refinance		
Other		
Other		
Other		
Totals		

The Profit Mastery Assessment (PMA) process utilizes the "Roadmap" to develop an action plan that is measurable and creates accountability.