UNCONVENTIONAL BUSINESS NETWORK
ROUNDTABLES

LESSON 15: Business Performance

Seven Keys to Financial Success

As we saw in the devotional, Proverbs 27:23-27 teaches that we are to know the condition of our flocks. This teaching has strong implications within that culture since the survival of many families depended upon the health of their small flock. This was not only important to them, but it was also important to families that had very large flocks. Knowing their condition was critical since large quantities of animals could be quickly lost to disease, starvation, predators and theft. Job 42:12 tells us that the Lord blessed Job with 14,000 sheep, 6,000 camels, 1,000 yoke of oxen and 1,000 female donkeys. Can you imagine what it would take to handle a business that size with the feeding, birthing and culling without the help of computers?

We find that this scripture translates well from the cultural setting 4,000 years ago to our setting today. Managing a business could be as complex then as it can be today.

Ongoing prosperity in business demands good financial stewardship that Includes a way for us to gauge success. You will find the *Seven Keys to Financial Success* woven into this lesson will help with your long-term success. Let's dive into these seven factors by listening in on a mock conversation Ray has with Jim and Wayne, manufacturers of store fixtures.

Jim begins by explaining, "Ray, two years ago we had one of our best years ever. Last year is a different story; our cash flow is terrible. We already show a loss of $60,000—and we are only two months into the new year. We need your help!"

"Well, let's see if I can help. To start, we will want to look at your *year-end* Income Statements for the last two years and your last year-end Balance Sheet. If you or Wayne could get me

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copies, we'll get things underway." As Wayne hands out copies, Ray explains, "The Income Statement will help me see the level of last year's revenue, your Gross Profit Margins and your bottom-line profit. The Balance Sheet is a report that helps me see a snap shot in time. It will tell me what assets you owned as of that date, how much you had outstanding in debts and ongoing liabilities—which will then let me see how much equity or net worth is remaining."

As he sat down at the conference table, Ray continued, "I want to use your financial statements to examine what I call the *Seven Keys to Financial Success* this afternoon. Do you mind if I take a moment here to calculate a few ratios before we discuss the seven keys?"

"Go right ahead, I'll get us all some coffee" said Wayne.

KEY 1 ➤ SALES

"Jim and Wayne, as I discussed earlier, there are seven key factors that reveal the basic trends in almost any business. Let's begin with the area that usually gets *too* much attention—sales growth."

Jim interrupted, "The lack of enough sales is our problem. If we could just get to $3 million, I'm sure we would be extremely profitable."

"I'm glad you brought that up, Jim," Ray said. "A common belief by many is that more sales is a cure-all, so let's examine your history to see if that is true."

"According to your financial information, five years ago you made more than $100,000 on only $1.8 million in sales. That appears to be your best year. Sales have grown tremendously since that time topping out last year at $2.8 million. What was your last year bottom-line ?" Ray asked, although he already knew the answer.

"Roughly a $70,000 loss," replied Wayne.

"That information would indicate to me that sales growth is not the problem," Ray concluded. While sales growth is important, it should be monitored in tandem with the other ratios. Intuitively, if you're losing money on each sale, more sales could break you."

"Ray, what financial ratio would you recommend we use that is beyond just total sales?" Jim asked.

I would begin with sales growth.

Sales Growth = (This Year's Sales - Last Year's Sales)/Last Year's Sales

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“Let’s go next to the second key factor to achieve financial success,” Ray stated as he steered the discussion away from the topic for now. He would give it more attention later.

KEY 2 ➤ GROSS PROFIT MARGIN

“If you have inventory in your business, or direct costs easily defined as Cost of Goods Sold (COGs), then you should be concerned with your Gross Profit Margin. The formula for this important ratio is … "

Gross Profit Margin = (Sales - Cost of Goods Sold)/Sales

“How successful you are at pricing and managing your direct costs is revealed by this ratio. Comparing the Gross Profit Margin to industry ratios and to your own (from previous periods) helps assess your effectiveness. The typical mark-up for your industry is just as important as your own internal data, since it gives you a good benchmark.”

Jim asked, “What kind of things should go into the Cost of Goods Sold section of your formula?"

“COGS include any direct costs to manufacture or produce the product or service. This includes labor, material cost, freight, and in a manufacturing business like yours, it also includes direct costs allocated to the manufacturing process. The latter comprises things like plant rent, utilities, etc.” Ray continued by showing a chart of Gross Profit Margin for their company and stated, "In 2017, Jim, you had a 28 percent margin, but in 2018 it declined to 26.5 percent.”

Wayne asked, “What impact did it have in dollars?”

“1.5 percent of $2.8 million is $42,000.”

“$42,000!” Jim snapped. “Wow, we need to figure out why this ratio is so out of line and then monitor it more closely.”

Jim needed to take a quick call, so Wayne and Ray decided to visit the break room to refresh their coffee. Ray prepared to explain the third factor to financial success, Operating Expense Margin.

KEY 3 ➤ OPERATING EXPENSE MARGIN

Ray explained to Wayne that operating expense, sometimes called overhead, is the easiest area to spin out of control. “Operating expenses,” Ray explained, “include mostly fixed expenses like rent, utilities, telephone, administrative payroll, etc. These expenses tend to creep up each

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year. Monitoring the Operating Expense Margin is helpful to stay on top of changes in this area."

"What's the formula?" Wayne asked.

Operating Expense Margin = Total Operating Expense/Sales

He then continued, "If you are examining profitability, comparing your Gross Profit Margin to your Operating Expense Margin will reveal if you can make a profit on increased sales. For example, if your business has been achieving a 27 percent Gross Profit Margin but your Operating Expense Margin is 29 percent, you will lose money, even if you grow sales."

KEY 4 ➤ PROFITABILITY

"What are you discussing now?" Jim asked as he reentered the room.

"We just finished discussing overhead," Ray responded. "Now let's talk about profitability. All businesses must make a profit to remain in existence, but how much is enough? Owning a business is an investment. Knowing how well your investment is doing is necessary to compare it to other investment alternatives. This requires a consistent standard of comparison. The best comparison is Return on Equity."

Return on Equity = Net Profit after Taxes/Net Worth

"Net Worth is the *remaining* investment in the business; Net Profit after Taxes is the return *on* that investment. This ratio allows you to compare the return on your business to other investments."

"Owners' compensation is a factor often overlooked. Business owners deserve two types of returns, a return on their investment and a return for their labor."

"So how do you compensate for this in your formula?" asked Wayne.

"Try substituting a reasonable salary you would pay someone to run your business in place of the current officer's salary. The resulting net profit, after this salary, can be used to divide by your net worth. This should be a closer reflection as to what kind of return you are receiving on your business investment versus your labor."

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KEY 5 ➤ LEVERAGE

“Let’s move on to the fifth key to financial success, Leverage. One of the most crucial ratios to a lender is the Leverage Ratio. I'm sure you’ve heard about using other people’s money in these get-rich quick seminars as a good thing. The banks recognize the flaw in this approach. When you use too much debt in a business, it goes broke.”

Leverage = Total Liabilities/ Net Worth

Ray continued, "This ratio allows the lenders and you to see what level of risk there is in our business at any given point in time. By comparing the debt in your business to the amount of capital remaining, they can determine how much the business owner has at risk compared to how much the lenders have at risk. The less risk they have, the better.”

Wayne, while glancing at Ray’s chart noted, “According to our numbers, here it appears we were at 1.67 in 2017 and now we are at 1.87. Explain those numbers please.”

“In 2018 you owed 1.87 times more debt than you had in equity. It’s important to note that anytime this ratio exceeds 1.0 it means you have more debt than equity, meaning your lenders are more at risk than you. This can place you in bondage to your lenders.”

KEY 6 ➤ GENEROSITY MARGIN

“The next key to success I want to discuss,” said Ray, “is what I call Generosity Margin. You won’t hear many financial analysts discuss this factor, but I believe it’s important, especially for Christian business owners.”

“If we believe God’s Word, we realize that God is serious about the principle that you will reap what you sow. God loves being generous to His people. If you sow generously, God will reward that act of open-handed giving.”

This formula is very simple.

Charitable Giving/Net Income before Charitable Giving = Generosity Margin

Ray continued, “We could have a long theological discussion, but most Bible teachers believe that the starting point for generosity is the Biblical 10% *tithe*. We can debate whether it should be given from gross revenue or net profit, but at a minimum, I believe it should be based as a

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percentage of your profit. The Generosity Margin calculation allows you to determine quickly if you met a minimum giving standard or not.”

Jim and Wayne looked at each other as Wayne said, “We already know we need to do better in that area without even calculating the Generosity Margin.”

KEY 7 ➤ TURNOVER RATIOS

Jim changed the subject by asking, “So what is the last key to success?”

“Turnover Ratios” Ray replied. “When there is a cash flow crunch, the most likely source of cash is on your balance sheet.” Ray continued, “If you consider how much money you have tied up in inventory and accounts receivable, you can quickly realize that those are items that need to be monitored.”

“In addition, you also need to know how slow or fast your accounts payable are turning over. If you stretch them out too long, you run the risk of losing a good vendor.”

Ray continued, "This key actually has three important ratios to monitor on an ongoing basis. Here are the three formulas … "

Accounts Receivable Turnover (days) = Accounts Receivable/Annual Sales * 365

Inventory Turnover (days) = Inventory/Annual Cost of Goods Sold * 365

Accounts Payable Turnover (days) = Accounts Payable/Cost of Goods Sold * 365

Ray then began his explanation, "These ratios will tell you how many days of receivables or inventory are on hand. For instance, if you typically give customers 30 days to pay, the account receivable ratio will reveal to you if your average account has creeped up to 45 days. Simply calling your customers and reminding them of your terms can greatly help your cash flow.

After a short pause, he continued, "Likewise, if your inventory exceeds your goal, you can easily determine how much cash can be raised by liquidating some inventory. Accounts payable is the flip side of the coin. Now you are tracking how far past due you are in paying your vendors in total. Depending upon your vendor philosophy, this can help you realize that you need to get better at paying them quicker so that you can take early pay discounts."

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DISCUSSION QUESTIONS

1. Not every business has inventory or accounts receivable.

a. Which of these ratios are pertinent for your business?

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b. Which ones do you personally feel would be meaningful for you to monitor?

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2. Do you have adequate and timely records to monitor these success factors? If not, what steps might you take to:

a. have adequate records?

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b. have timely and consistent records?

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3. Are you the primary person responsible for tracking financial information? If yes, to what extent are you comfortable and/or have the time to fill this role? Is there someone equally or more qualified who can help you with this aspect of your business?

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4. In Jim Collins' book, *Good to Great*, he discusses the "Hedgehog Principle." This is the one key ratio each business should focus on that is unique to their business. Is there a key ratio or statistic crucial to the success of *your* business that you regularly monitor? ______________________________

Consider what this ratio is and how you track it. For example, many professional services firms track closely the percentage of billable hours to total work hours. Contemplate how this ratio and the ones studied can best help you manage the financial health of your company.

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SEVEN KEYS TO FINANCIAL SUCCESS

The following chart is a summary of the seven keys that you should track on an ongoing basis. It will become more meaningful over time as you track your own trends. Keeping this chart as a monthly guide can help you become more financially successful.

The Seven Keys to Financial Success

Key 1 ➤ Sales Growth .... (This Year's Sales - Last Year's Sales)/ Last Year's Sales

Key 2 ➤ Gross Profit Margin .... (Sales - Cost of Goods Sold)/Sales

Key 3 ➤ Operating Expense Margin .... Total Operating Expenses/Sales

Key 4 ➤ Return on Equity .... Net Profit after Tax/Net Worth

Key 5 ➤ Leverage .... Total Liabilities/Net Worth

Key 6 ➤ Generosity Margin .... Charitable Giving/Net Income before Charitable Giving

Key 7 ➤ Turnover Ratios:

a**. Accounts Receivable Turnover** (days) .... Accounts Receivable/Sales * 365

b. **Inventory Turnover** (days) .... Inventory/Cost of Goods Sold * 365

c. **Accounts Payable Turnover** (days) .... Accounts Payable/Cost of Goods Sold * 365

Once you understand these seven factors, I challenge you to use these as part of your management information each month. Once a month, a quick glance at these seven factors compared to your previous month's figures will give you the information you need to become financially prosperous.

To receive help with these ratios and get benchmarking numbers to see where your business stands with others in your industry, please contact your local **Small Business Development Center.**

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