A Guide to Creating and Managing a Profitable Business

Finance without Fear

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Published by The Institute for Finance and Entrepreneurship, LLC
Windham Center, CT 06280 USA
(860) 456-4477
www.financewithoutfear.com

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Book design by TLC Graphics, *www.TLCGraphics.com*
Cover: Monica Thomas, Interior: Erin Stark

The publisher greatly acknowledges all of those who reviewed copies of the manuscript and covers throughout the creation process. Your input was invaluable.

Library of Congress Cataloging-in-Publication Data

Hettinger, William, 1955 –
Finance Without Fear: A Guide to Creating and Managing a Profitable Business / William S. Hettinger, John Dolan-Heitlinger

p. cm.
Includes index
ISBN-10: 0-9828917-0-4
ISBN-13: 978-0-9828917-0-4
1. Finance. 2. Financial statements. 3. Business enterprises – Finance.
4. Corporations – Finance.
I. Hettinger, William S., 1955 – II. Dolan-Heitlinger, John, 1952 – III. Institute for Finance and Entrepreneurship (firm) IV. Title

Proudly printed in the United States of America

CHAPTER FIFTEEN

Using Financial Tools to Manage Your Business

The prior chapters have presented a series of tools that can be used to analyze financial statements and identify how your business stacks up against the competition and the industry. In this chapter, we bring together these lessons and summarize how these tools can be used to evaluate the effectiveness of your business strategies and the management of your cash during the operation and growth of your company.

Focus on Your Strategy

We began this book by discussing the need for any company to have a strategy that will allow the business to differentiate itself from the competition and build a competitive advantage. Creating and maintaining a competitive advantage is one of the keys to making money.

In Chapter 1, we introduced the four key strategies a business can use to create a competitive advantage:

1. Innovation and design
2. Operations
3. Sales and marketing
4. Customer service

We also discussed the need for a business to be either customer-centric or operational-centric. A customer-centric business competes by providing high value to its customers, while an operational-centric business competes by providing its products and services very efficiently.

Customer-Centric

A customer-centric business focuses on providing real or perceived value to customers so they are willing to pay more for the business's products or services.

A customer-centric business needs to be able to translate this CUSTOMER FOCUS into a higher price.

The key strategies for a customer-centric business are innovation and design, sales and marketing, or customer service. When used effectively, each of these strategies will help the business provide products or services that have value to the customer.

When a product or service has a real or perceived value to customers, they should be willing to pay a higher price for the product or service. Hence, a successful customer-centric business will be able to charge a higher price for its product or service.

A business that's using one of the customer-centric strategies and doesn't obtain a higher price for its products or services is either not effective in the use of the strategy, or hasn't correctly priced its products. A customer-centric business needs to be able to translate this customer focus into a higher price.

Businesses that are able to successfully implement customer-centric strategies include pharmaceutical companies; manufacturers of

medical, scientific, and specialty equipment; name-brand consumer goods manufacturers; and some clothing and specialty retailers.

Businesses that use customer-centric strategies will have higher operating expenses. For example, a business that uses an innovation and design strategy typically will have to spend money to develop and design its products. This cost will be reflected in its operating expenses. Likewise, a business that uses a sales and marketing strategy will have higher operating expenses associated with its sales and marketing efforts, and a company that uses a customer service strategy will have higher operating expenses that reflect the costs of providing this customer service.

A business using a customer-centric strategy must be able to translate the higher price it receives for its products and services into a higher gross margin. This higher gross margin will allow it to pay the higher operating expenses and still earn a profit. If a customer-centric business isn't able to obtain sufficient prices or margins, it won't make money.

Operational-Centric

An operational-centric business is the opposite of a customer-centric business in many ways. Instead of focusing on differentiating their products to obtain a higher price, operational-centric businesses concentrate on manufacturing and distributing their products as efficiently as possible.

The gross margins for businesses pursuing an operational-centric strategy are low. Customers perceive very little difference between companies and are less willing to pay a higher price for products that they perceive to be very similar. As we noted in the examples in the earlier chapters of Part 3, this can include food and beverage retailers, oil and gas retailers, discount and low-price retailers, as well as manufacturers of many consumer goods.

As a result of earning lower gross margins, an operational-centric business must also have lower operating expenses because it won't be able to spend significant amounts of money on innova-

tion and design, sales and marketing, or customer service. The operating expenses must remain low so the business can obtain sufficient operating profit and net profit.

Although its gross margins are low, an operational-centric business often has a large sales volume. This large sales volume allows the business to make a sufficient gross profit so it has money available to pay its operating and other expenses.

An operational-centric business that doesn't CONTROL its cost of goods sold and operating expenses won't make MONEY.

An operational-centric business that doesn't control its cost of goods sold and operating expenses won't make money. An operational-centric business with a low sales volume may also have difficulty making money.

In many instances, a customer-centric business develops into an operational-centric business as its products mature, become more accepted in the marketplace, and competitors begin offering the same products. When this switch occurs, a business that had been customer-centric will need to switch strategies to become more operational-centric and reduce its operating expenses accordingly.

This switch from customer-centric to operational-centric occurs frequently in the market. For example, a business that introduces a new electronic product is able for a time to earn high margins on that product. As other competitors develop similar products, the margins begin to fall, and successful businesses in the market must pursue an operations strategy rather than an innovation and design one. A similar event takes place in the clothing and fashion industry. For a time, a new product is able to earn high margins due to its desirability and uniqueness, but over time the product will become widely available, margins will fall, and to remain successful, a business manufacturing or selling these products will need to pursue an operational-centric strategy.

Focus on Your Cash

Many of the earlier chapters in this book have focused on cash. Chapters 3 and 4 focused on the contents and importance of the cash flow statement. Chapter 6 discussed the difference between cash and profit, and why a profitable business needs both. Chapter 11 focused on a business's working capital and ways to measure how efficiently a company is managing its cash. Chapters 12 and 13 focused on the ratios that can be used to tell if a business can pay its bills and pay the bank.

This leads us to a very important rule: To be profitable, a business must manage its cash. The most common reason a business will fail is that it runs out of cash. Without cash, a business won't be able to pay its bills, pay its staff, or pay its owners.

A business can run out of cash when:

- It's not converting its inventory into cash fast enough.
- It has too much cash tied up in inventory.
- It offers payment terms that are too generous.
- It's growing too fast and doesn't have enough cash available to support its growth.

For a business to be successful, it will need cash for operations and growth. The business owner must be aware of the amount of cash needed to keep the business operating and to grow the business.

Operating the Business

In Chapter 11, we introduced the concepts of working capital and efficiency ratios. Working capital is the difference between current assets and current liabilities, or the amount of cash that must be left in the business so bills can be paid as they come due.

Efficiency ratios measure how many days of inventory stays in the business before it's sold, how quickly the company collects payment from its customers, and how fast the business pays its suppliers. Collectively, efficiency ratios can be used to calculate

a business's cash conversion cycle and measure how quickly it's able to convert its inventory into cash.

The more quickly a business is able to convert its inventory into cash, the less working capital it will need. A business can use several strategies to increase its cash conversion cycle.

One of the most effective strategies is to reduce the number of days in inventory. Purchasing inventory costs businesses money. To the extent that the amount of inventory a business carries can be reduced, the profitability of the business can be increased.

**To be PROFITABLE,
a business must MANAGE its cash.**

This is the secret behind the just-in-time inventory system made popular by the Japanese automakers. Rather than purchasing a significant amount of raw materials and production parts ahead of time, automakers make purchases a day or two ahead of the production process, thereby minimizing the amount (and cost) of the inventory they purchase.

While it's more difficult for a retail business to use a just-in-time inventory process because the store needs merchandise on the shelves, it's often possible to receive more frequent deliveries from suppliers and reduce the amount (and cost) of inventory stored in the warehouse or in the back room.

Accountants classify inventory as an asset. From an operations perspective, inventory is an asset that has a cost to the business, and a company that minimizes the inventory it owns can increase its profitability.

A business can also increase its cash conversion cycle by managing and monitoring its collection and payment period.

As discussed in Chapter 11, retailers and consumer-focused services typically get paid very close to the time of sale, while manufacturers, business service organizations, and medical practices often get paid in 30 to 90 days or more.

It's often impossible for a small business that sells to a large customer to dictate its payment terms. The small business will have a collection period that reflects the terms offered by its large customers and the practices of the industry. In these instances, a business will need to make sure it has sufficient cash available to pay its bills as it waits for payment from its large customers.

As a business grows, the amount of WORKING CAPITAL needed grows as well.

A business will have much more success in setting its payment terms when dealing with businesses of comparable size. However, just because a business isn't able to establish its collection period in all instances doesn't mean it shouldn't monitor its collection period. The business owner or manager should be aware of the payment terms extended to customers and monitor the collection period for adherence to these terms. In this way, the business can be assured it's collecting its cash as efficiently as possible. Likewise, the owner or manager should be aware of payment terms offered by its suppliers and should take as long to pay its bills as its suppliers allow.

Growing the Business

As a business grows, the amount of working capital needed grows as well. That's why the cash conversion cycle of a business is so critically important. The faster a business is able to receive cash for the sale of products, the less working capital it will need. If a business has a long cash conversion cycle, it will need more working capital to grow than if it has a short cash conversion cycle.

When a business grows and needs more cash for working capital, there are three possible sources of this cash:

1. Additional investment by the business owner
2. Borrowing from the bank or another lender
3. Cash generated from operations

A business that wants to grow quickly will generally need a significant additional owners' investment or will need to borrow. If a business borrows, it will incur additional interest expenses associated with these borrowings.

However, if a business chooses to grow more slowly, it may be able to generate the additional cash it needs from its operating activities and the efficient management of its cash conversion cycle. A company that chooses this path won't incur extra interest expenses and won't require additional investment from the owner.

As the company grows, it's critical that the business owner or manager understands the cash needs of the business as more units are sold or more services are provided. It's also important that they've identified a source of this cash to fund this growth. If the business grows too rapidly and doesn't have the cash available to fund this growth, the business could very easily run out of cash and find itself unable to pay its bills.

Use Your Tools

To summarize, let's review the ways financial tools can help you create and keep a profitable business.

- Profitable businesses will use customer-centric or operational-centric strategies to obtain a competitive advantage.
- Profitable businesses will translate a high gross margin into a higher operating profit and net profit.
- The faster businesses are able to turn over inventory, the more profitable they will be.
- Businesses can achieve cost savings by minimizing the amount of inventory.
- Companies can become more profitable by improving their cash collection cycle.