Costeff Consulting • The Small Business Olympics

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Budgeting with your P&L For Turnaround and Restructuring
Creating Goals for your Managers
Pricing Formulas, Locating Excess labor and materials costs

Business is a team sport and the financial statements are the scoreboard. You may think they are mostly for tax purposes and for your CPA. But in fact that was an afterthought. To understand your business, to run it, to grow it, it is essential you REALY get to know and understand the numbers of your own business, better even than the CPA. We call this Cost Accounting, or Managerial Accounting. Most bookkeepers, accountants and CPA's do not know, or do not take the time to teach you how to do this. They do Tax Accounting, and for that they need the numbers in a different format, and at a different times than those that are useful for you to run your business, so the first lesson, is that the numbers are now your responsibility.

A business is a living being. It has a life of its own. It wants to grow. It has 3 main functions. Sales (SLS), Operations (OPS) and Finance (FIN). If any of these functions are not working the business is dead.

Sales is the act of getting customers go give us an order. Salespeople are Creative, Optimistic, People Persons, who can figure out what the client wants before he knows it, and who's mantra is: "the customer is always right". They are fine with long term perspective. They are like politicians, they want your vote (order). Their element is People. They want them to be happy. They may even give the farm away to do that. They are like the Quarterback in Football, they set up the play. They are notorious dreamers and not always realistic. Their success is measured by the number of new customers, or the additional new dollars of sales they bring in. In the P&L this is called the Percentage Growth of Sales.

Operations (or Production) is the act of getting the job done. Whatever the customer is paying for, must be produced or delivered: On Time, On Budget, Per Spec (Quality). People who deal with operations are schedule driven. They have labor coming in, as well as materials/merchandise, and they have to get work done in a timely and efficient manner. Their mantra is "do it right, the first time". Their element is technical/material. They want to do it right. They only appreciate people who understand their trade/technology. They have a short term perspective, next week max. Labor called in sick this week, the materials needed to get this job done won't be here till Tuesday, and the customer expects it on Friday. They are like the Offensive, like a Wide receiver in football. They are all about efficiency, (yardage gained). Their success is measured by their efficiency in producing the most goods or services, with the least labor and materials (inventory). In the P&L this is called the Gross Profit Percentage. We'll come back to that later.

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The last discipline is Finance. (FIN). These people are like bankers, we call them Bean Counters. They don't primarily care about making the customer happy, or doing it right, they ask : are we making money? They always feel worried, because a business is risky thing. We put money in and are never sure it will come back. For that reason they are carful, conservative, and risk averse. We train them to bet that way. This attitude balances the enthusiasm of the SLS and the pride of the OPS in their technical ability. The FIN function is primarily a feedback mechanism, to tell us what is happening. Since this is business, the language is in Dollars. It is like your dashboard on your truck. It does not really give it power or transfer the power to the wheels, but it tells you what is happening so you can drive it smarter. We can think of the FIN function as a referee in the game, or Jaimini Cricket for Pinnochio. Its job is to collect numbers and analyze them to make sense of what is happening, and answer the one question in many many ways: are we making money?

Each Function "Owns" a set of resources, and authorities that are needed to get its job done. These show up in the Profit and Loss Statement (also called Income Statement, or P&L). IF the P&L is set up properly for managerial accounting (not often!), they would look like this:

SLS, would list all the dollars coming in from our customers. If done right, they would list them in separate Revenue Streams, that have been decided on by the owner, and that help him see what is happening with his most important groups of customers.

So SLS are responsible for all line items related to Sales and Revenues, including Credit Card fees for transactions, promotions, returns, free shipping etc. So you see, that not all of these are Income for the business, some are expenses. If the SLS mgr. has some expenses that are used to generate more sales, they are his responsibility. There are another group of expenses that belong to sales. All the advertising, charity, community service, wining and dining customers, trips to trade shows, brochures and mailings to customers, salespersons salaries and commissions, etc. etc. all belong to the SLS.

The primary metrics for SLS mgrs. Are:
The DELTA growth of total net sales (net of returns, etc) as a percentage of sales of the previoius period. As in: " grew 12% in sales relative to 2008."
The second metric is: Total Marketing expenses (salespeople, advertising etc) as a percentage of Total Net Sales Revenues. "Last year total marketing expenses were 2.5% of sales, this year they are just 2.3% of sales".

OPS owns all the expenses that are incurred to create the service/product and deliver it.
This usually includes a very large slice of the resources of the company. Typically it is all Direct Labor, inventory (Materials/COGS), sub-contractors and outside services – Subs (for operations), equipment costs, and any other costs associated with creating the product.- called Other Direct. Typically the OPS mgr controls the workers, their schedules and hours, their pay, as well as the ordering of Materials, managing inventory, maintaining equipment for production etc. You can see this is a big job.

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The primary metrics for OPS mgrs. Are Gross Profit as a percentage of Sales.
Gross Profit is calculated by adding up all the Direct Expenses (Labor, Mtls, Subs, Other Direct) and subtracting that from Net Sales. That gives us the Gross Profit in Dollars.
Those dollars divided by the total dollars of Net Sales, give us the Gross Profit Percent. This is a really key figure.

Note: if we do not include All our direct costs in the Total Direct costs, and keep a lot of them "below the line", in our overhead, then Gross Profit will be looking better than it is. This often happens when bookkeepers, or CPA's to whom it does not matter much for their tax work, put together our Chart of Accounts in our accounting system.

The most volatile expense, and the one that tends to go out of bounds, is Direct labor. It is worth keeping an eye on.

The key metrics for on OPS mgr. are:
Gross Profit as a PCt of SLS
Labor Costs as a PCT of sales, and how much that changed from last period
Mtls Costs as a PCT of sales, and how much that changed from last period
Others, that are more useful for showing the workers, are :
Labor Productivity (Widgets per Man Hour, etc.)
And Inventory Turns, and Contribution by Category, Product, Floor space, etc.

FIN owns all the other expenses. Those that are typically NOT directly tied to production or sale of our services or goods. This usually includes several groups: Facilities (rent, utilities, maintenance), Communications (phone,. Cells, faxes, web, mail), Finance (bank fees, credit card fees, interest payments, depreciation/amortization), Office (printers/copiers, tea and coffee, paper PC's etc) and Misc.

The total of all of the above expenses are called Overhead (O/H), or General and Administrative (G&A). If we allowed the SLS mgr or the OPS mgr to decide on them, they would use them for THEIR departments, so we let the FIN mgr. be responsible for them.

The key metric for a FIN. Mgr is:
Total O/H as a percentage of SLS.
This, together with the Gross Profit percentage are THE key numbers in a business, yet 90% of business owners do not know what they are for their business.

Creating a Financial Model
Here is a spreadsheet that you can use to see how each of your managers is doing, and so all of the team can see what has to be done to reach our goals. It is named "Management Team P&L, it looks like this:

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Your Business - Management Team P&L Report

Mgr Acctble	For Line Item	Dollars	+/-	% of SLS	Action
Ed	**Sales**	$ 3,869,952	+	100%	
Ed	Food	$ 1,426,340	+	37%	
Christina	Beverages	$ 2,360,839	+	61%	
Christina	Other	$ 82,773	+	2%	
John Doe	**Direct Expenses**	$ 3,009,329	-	78%	
Allison	Materials/Food	$ 2,811,390	-	73%	
Beth	Dir. Labor	$ 197,939	-	5%	
Allison	Subs	$ 32,000		1%	
Allison	Other Direct	$ 12,000		0%	
Joan	**Gross Profit:**	$ 860,623	=	22%	
Ed	**Marketing Expenses:**	$ 49,000	-	1%	
Ed	Advertising	$ 14,000		0%	
Ed	Other Marketing	$ 35,000		1%	
Lucy	**Overhead Expenses**	$ 290,000	-	7%	
Ed	Owners Salary/perks	$ 75,000		2%	
Lucy	Office Labor	$ 45,000		1%	
Lucy	Facilities	$ 85,000		2%	
Lucy	Communication	$ 12,000		0%	
Lucy	Financial	$ 25,000		1%	
Lucy	Other OverHead	$ 48,000		1%	
Ed	**Profit Goal**	$ 464,394	-	12%	
THE TEAM	**Over/Under Goal**	**$ 57,229**	=	1%	

The Fine Print

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You may have noticed that all the key metrics for your managers show up clearly in this report, and that the areas each is responsible for are grouped together. It now becomes possible to "give" each line item to a specific manager. Marketing Mgr. gets all the sales lines and the expenses related to sales. Ops Mgr. gets all the direct expenses, and the Gross Profit, and The FIN mgr. gets the overhead. The Profit Goal is defined by the owners and the FIN Mgr., and the Bottom line result, of meeting, exceeding or falling short is the only line that is a joint responsibility.

This is the scorecard of the business. You can use it to compare the percentage each Mgr. has spent in his area as a percent of total sales. Comparing several periods, such as weeks, or months to the last period will show up any trends you have to be aware of. These numbers only give you a sign that perhaps something is happening. You dig deeper in Management Team meetings, or one on one with your manger, to see why the number are up or down. You then take some corrective action, and there is a column to write that down. It may take a few tries to fix a problem trend. But at least we are all aware of it and trying to fix it. This is very educational to your managers. They begin thinking like owners. So you can begin sleeping better.

Managerial or Cost Accounting:
CPA's and Bookkeepers focus on Taxes. For that they need the numbers to be accurate to the penny. It is not as important for them to get the numbers fast. They do the taxes after the year is over. This is an important task, because they keep you legal, and they find ways to minimize your tax burden. However knowing your numbers at the end of the year, or even the month is not veryh usefull for running a business. Especially when the CPA does not understand your business, and as often happens uses, a boilerplate Chart of Accounts (The line items of the P&L) that is most often alphabetical (Advertising at the top, Payroll and Rent at the bottom). Since Payroll is mostly composed of Direct Labor, it means that direct expenses are now put into overhead. That does not leave the OPS manager any easy way to see if his labor costs are going up. Since he is not a bookkeeper, he will let it slide, and you will be the loser. In 17 years of consulting to hundreds of small businesses, I can count on one hand the number of CPA's that were aware of this problem, and knew how to help their clients, and did something about it. So lesson no. 1, Do not count on your CPA to run your business, organize your financial reporting, or create a managerial format for your cost controls. They will not do it.

Managerial Accounting wants the numbers in real time, today, this week, before the losses or costs run out of control, so the owner can take corrective action. We want to know why things are going out of whack and where that is happening, and who we can turn to to fix it. We do not care about the exact pennies, but want round numbers, fast.

It is very possible, if we set the systems up right to have both. This is a key skill that CPA's do not focus on. It requires knowledge of the business, and then knowledge how to create the financial model in the accounting system that reflects it in a way the owner and managers can grasp easily, without a lot of work.

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Here are the main steps.

1. Set revenue streams that mean something to the owner

Revenue streams are line items that break the total sales into meaningful groups. This must be done with the owner. Theoretically we could lump customers alphabetically, but that is not terribly useful to most owners. A construction company could have Residentail and Commercial projects, a restaurant Food and Beverages Sales. We might divide sales into geographical areas, especially if we have separate salespeople in each area. We might divide the sales into kinds of merchandise that have different profit margins, or that have different lead times to re-order. We might look at repeat customers, and New customers, Or old lines, and new lines that are in R&D. There are many possiblities, and by interviewing the owner, it is possible to create the best fit for him. Of course by choosing one way of categorizing sales into different buckets, we give up on doing it in other ways. But often we can also get that info in other ways. So right now we choose the most useful way to divide sales into groups, or Revenue streams.

2. We always have a misc. or Others revenue stream to catch misc. sales that do not fit the other boxes. It is also good to have line item that deducts from sales things like taxes, returns, freebies, Merchants fees for credit cards, and then to have a line of "Sales Net of sales tax/CC fees/returns etc"
3. The next group of line items are direct expenses. These are typically divided into 4 categories: Direct Labor, which should include all the payroll expenses, health insurance, payroll taxes, Medicare, workers comp. workers training, uniforms company picnics etc.
4. Then comes Materials – which could include merchandise for resale, food and beverage costs (good to split these in a restaurant), and any shipping costs, damages, shrink etc, associated with them.
5. Then come Subs/outside services.
6. Then comes a catch all of Other Direct expenses. .These could include supplies, vehicles (payments, field, insurance. Repairs) , Nextel's, Travel to job sites food and lodgings, etc.
7. Gross profit deducts total direct expenses from Net Sales.
8. Overhead is best kept simple.
9. We have a line for Sales Labor, commissions, salaries, expenses
10. and a line for Marketing expenses, that could include Advertising, printing, web, travel, donations, samples, freebies, signage etc.
11. Then we have a line for Owners, which includes their salaries/draws, perks, health insurance, IRA, vehicles and gas, etc.
12. and a Line for Office labor, including like Direct Labor all the incidentals and labor burden.
13. Then we can summarize the rest of the Overhead Expenses into: Facilities (Rent/mortgage, repairs, utilities) Communications (phone, mail, FedEx, cells, web), Financial (interest payments, bank charges, CC charges, and Other Overheads which is a catch all.
14. We always want to put in a profit goal, that is set by owner and FIN mgr. To see if we are over or under it. That way we are shooting for profit, not break even.

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HOW TO USE THE P&L

There are many uses for your P&L. It is a model of your business, so it is very useful.
The main uses are:

1. To restructure a bus. In a turn-around situation
2. To determine what the front end and the back end of the bus. Are contributing, and see who should be improved.
3. To set pricing formulas, or bidding systems
4. To determine the volume me of sales needed to support a certain overhead, or how much overhead has to be cut at a certain level of sales.
5. And on and on. These are often used after a Business Analysis is performed, to help the owner locate profit leaks in materials, Low labor productivity, high overhead, or low gross profit, and to correct them to ensure a healthy bottom line.