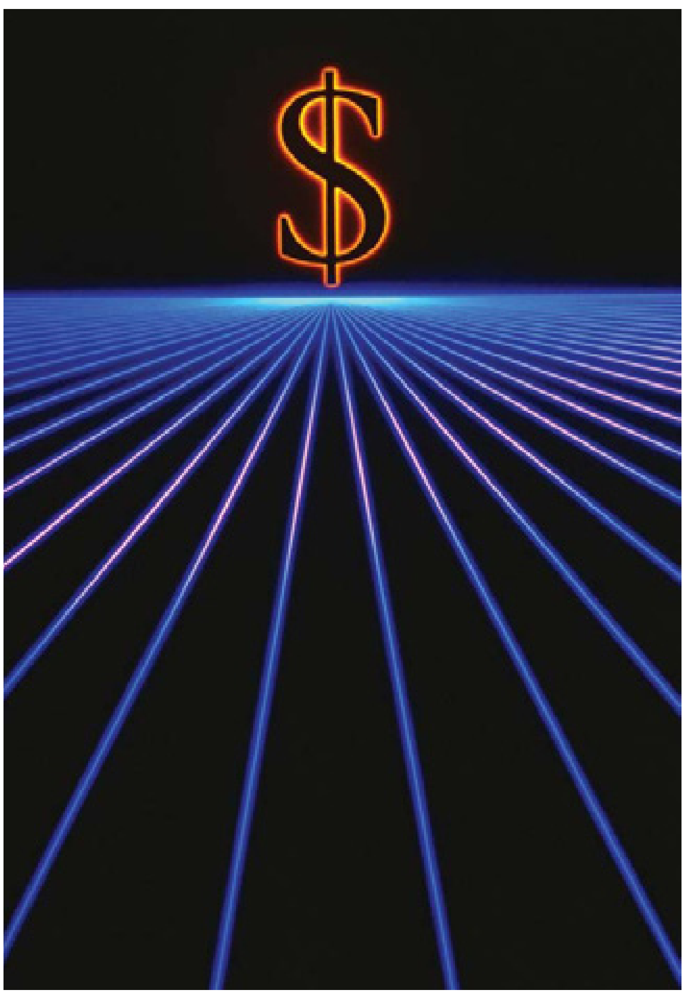
by Ralph Gotto

Roadmaps, JIT's and Squeaky Wheels
Success Monitors for Business



Businesses don't run themselves. Someone is always behind every dollar of company spending with authorizations made through purchase orders (PO's), time cards, hiring contracts, expense reports and credit cards. Luckily, executives can learn to monitor these and other critical barometers and keep their company out of the turnaround game.

As a CFO, I have spent a significant portion of my career completing turnarounds. By setting up monitors, I was able to gauge, on a timely basis, the direction and speed a company was moving.

One of the first things I did in a turnaround was to have all expenditures flow through me. The only way to stop the bleeding is to stop the spending. Once I apply the tourniquet, I find ways to improve the revenue flow, increase the collections of receivables, reduce inventory and stretch payables.

I call the monitors "Critical Success Monitors for Business." I have used these in small companies ($20 million in sales) and large companies ($200 million in sales) both domestically and internationally. These monitors depend on viewing them against a benchmark (budget or last year's actual for the same time frame). This contrast will give a view of the trend. If under in sales, gross margin and days payable or over in expenses and days of receivables and inventory, analyze why and take corrective action. By taking action immediately, rather than waiting until the month is over, many times you can salvage the month's profit.

What Are the Monitors?

1) Sales
(Roadmap Monitor)

Sales should be monitored on a daily basis. All companies except start-ups have historical trends and should have budgets. Use these roadmaps. Unless new products or other marketing programs are implemented, trends for most companies remain consistent. Reporting daily sales against the budget or historical past is the major lifeline to making your projected profit for the month. If a shortfall is seen in the first two weeks, you still have time to take corrective action to meet the budget.

2) Gross Margin
(Pinpoint Monitor)

Like sales, gross margin should also be monitored on a daily basis. If sales are trending along the budget line and gross margin is slipping, it may suggest a different mix in products shipped or services provided. Monthly monitoring of the gross margin by product and by customer can pinpoint causes of a profit shortfall.

As the CFO of a company in the medical services industry, one of my first responsibilities was to figure out why the company was losing money. The managers were convinced that all customer contracts were making the budgeted gross margin. Since this was a service organization, managers believed an analysis of customer contracts wasn't possible. It was, however. After an in-depth analysis, all contracts were making the budgeted gross margin except for one. Yes, even service companies have gross margin, and it can be determined. One contract had a negative gross margin that took the whole company into a loss position. This contract was renegotiated, and the company went on to a 12 percent return on revenue. Historically, you will find that a lack of margin performance can be attributed to one or two bad customer contracts or to one or two poor products.

3) Expenses as Percent of Revenue
(Below-the-Line Monitor)

All below-the-line expenses such as sales, marketing, general and administrative and research and development must be monitored on a monthly basis. Since these expenses are usually budgeted relatively flat, they are unaffected by volume and should track budget. Monitor these for total dollar expenses and as a percent of revenue.

4) Days of Receivables
(Squeaky-Wheel Monitor)

Monitor the days to industry standards and do it monthly at a minimum. Weekly is preferable. This indicator determines the cash inflow that is needed to pay your other bills. To keep receivables low, you need consistent follow-up of all overdue accounts. This means calling daily to see when the account will be paid. Remember, "the squeaky wheel gets the grease." In order to avoid incoming calls, many accounts payable supervisors will push your account to the front of the "to-be-paid" pack and move someone else back.

5) Days of Inventory
(JIT Monitor)

These days should be monitored monthly at a minimum, preferably weekly, and also to industry standards. This indicator will let you know if you are staying within your inventory budget for this level of sales volume. Going outside the budget without additional sales will cause a cash crunch.

In the past several years, just-in-time (JIT) inventory has lowered inventory levels and loosened up a lot of

Formulas

Receivables Days = Dividing your last three month's sales by 90 to equal a days sales and then divide trade receivables value by the days sales to calculate days.

Inventory Days = Dividing your last three month's cost of sales by 90 to equal a days cost of sales and dividing the inventory value by the days cost of sales to calculate days.

Accounts Payable Days = Dividing your last three month's cost of sales by 90 to equal a days cost of sales and dividing the accounts payable balance by the days cost of sales to calculate days.

cash. JIT has had an effect on lowering the current ratio of companies. Be aware that the current ratio should not be a part of the loan covenants, as any operating efficiency (JIT) could trip this covenant.

6) Days of Accounts Payable

(Interest-Free Loan Monitor)

Payable terms should be negotiated to stretch the payable amount as much as possible. Different industries have different historical standards. Accounts payable is sometimes referred to as an "interest free loan." Stretching of terms must be negotiated. If not, one of the vendors supplying a critical part may end up becoming the bottleneck of your production process. These days need to be monitored monthly, preferably weekly.

All the above Critical Success Monitors depend on having an integrated budget system and a ten-day-or-less reporting (closing) cycle that reports monthly results. For an integrated budget system, expenses need to be budgeted down to the department and project level, with a manager assigned to each, and rolled up to the income statement and balance sheet. This roll-up integrates the budget system. With a 30-day closing cycle, you are delaying by one month any corrective action. Weekly monitoring will enable you to forecast (Flash) results for the month. By the time you are ready to close, all that is required is validating your flash results with actual results. In fact, with today's technology and computers, a two-day closing cycle is possible. I have personally taken two companies from 90- and 30-day closes to two-day closes.

Generally, companies should have a board of directors or advisors. This is advantageous for both large and small businesses. Three fourths of these directors should be from outside the company and have diverse background disciplines.

Very small companies can get by with a business coach as an advisor. Communications with the coach can be made via phone or email, thus saving the small business time and cash resources.

The trends of sales, gross margin and days receivables versus the budget will monitor cash inflows. Cash outflows are monitored by the expense, inventory days and accounts payable days trend. The inflows and outflows comparison will show whether you are exceeding budget or falling behind.

Combining days of receivables and inventory, and subtracting days of accounts payable, will also give you the cash conversion cycle. You should use accounts payable to offset inventory so that you have only receivables left to finance.

Monitors give you the ability to take immediate corrective action. Using them is critical for the success of your business.

Ralph Gotto is a turnaround, profit-improvement and business-streamlining specialist with over 30 years of cross-industry success in public, private, domestic, international and entrepreneurial corporate environments of all sizes. He has served as chief financial officer, chief operating officer and business consultant in over twenty different industries. Ralph holds a BA in accounting from Loras College in Dubuque, Iowa and an MBA in finance from the University of St. Thomas in St. Paul, Minnesota. He also holds NASD licenses 7, 24, 28, 63, and is an adjunct professor of the MBA Program at the University of St. Thomas and Keller University. He has a black belt in karate and is a competitive tennis player. Ralph can be reached via email at gottorn@frontiernet.net.