EXPOSE HIDDEN PROFITS!

How to reach greater profitability through financial insights

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INTRODUCTION

Most business owners and entrepreneurs aren't engaged enough with their financial statements. Are you one of them?

While business owners follow their passion, that alone isn't enough to guarantee success. If I could name one difference that I see between successful individuals and those that are just running on a treadmill it is in their ability to understand their business through the numbers.

Running a company, large or small, requires understanding the ideal business model, knowing where you stand against that goal, and constantly striving to close the gap.

Don't be intimidated by the phrase "business model" . . . it is nothing more than a plan of how your business makes money. For some, particularly those that are seeking outside sources of capital, this means a detailed financial model and written business plan. For others, it can actually be quite simple. In fact, when I started providing fractional CFO services, I could express my entire business plan on a single index card. Simplicity is good!

If you are one of countless business owners or entrepreneurs who are intimidated by their financial statements, join me as I take you through twelve steps that will help you better understand your business and expose hidden profits at the same time.

CHAPTER 1.

IS IT OBVIOUS?

1. IS IT OBVIOUS?

Common terms benefit both internal and external consumers of financial statements

Make it easy for people (and yourself) to follow your financial statements. Use words that are descriptive and be consistent. Keep in mind that your banker and board members look at reports from multiple companies – use standard language that others will easily be able to understand and interpret. Make it easy for them to compare your business to others in a similar industry that crosses their desk.

Too often, I see financial statements that are "jumbled" for lack of a better term – income statements are not broken down into logical categories (employee expenses is my favorite example – salaries are in one place, healthcare in another, employment taxes somewhere else). The business owner can't tell the cost for employees for a given month. Or the income statement is alphabetically organized – what are the odds that your most important costs begin with A and your least important costs begin with the letter Z? Or they reflect how the business was run ten years ago, not how it is being run today.

I have seen balance sheets with no distinction between short term and long term assets. In one case, I found that a company had a negative fixed asset value which was obvious once the balance sheet was properly structured. They had recorded too much depreciation in prior periods.

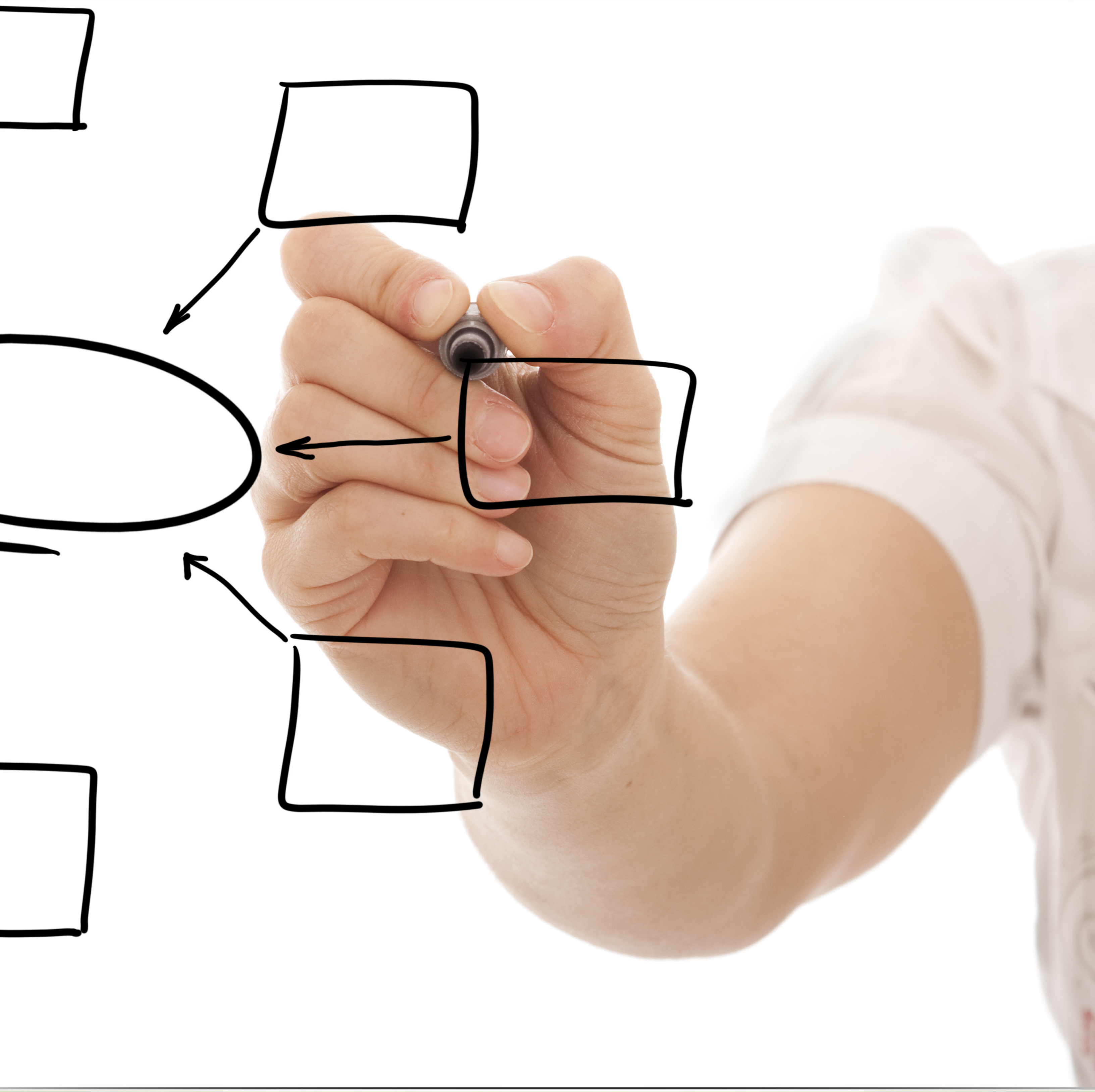
1. IS IT OBVIOUS?

It is amazing to me how many times I ask a business owner a question about his or her financial statements and they cannot answer them! One time, I asked a CEO if his statements were "cash" or "accrual" based – he didn't know and said: "Can you tell?" I said, yes, the problem with them is that I can tell just by looking at them that they are a mix of both – this CEO was trying to get investment dollars from a New York based private equity firm but couldn't even put a proper set of financial statements in front of them – by the way, it was the private equity firm who introduced us! Wonder why?

The key point is that you need to make your financial statements work for you. Make them obvious.

CHAPTER 2.

A PICTURE IS WORTH A THOUSAND WORDS



The organizational chart is a great schematic –
if you are large enough to report against
various departments –
use the organizational chart as your guide

The organizational chart is a great visual that helps people quickly understand roles and responsibilities. If you have cost centers, make sure that your cost centers have a logical link to the organizational chart and related responsibilities. Doing so, means that people won't have to wonder how cost centers on the financial statements are organized or developed -- they'll be able to look at an organizational chart and know in an instant.

I know of one company that is very sophisticated yet almost never publishes an organization chart – it is amazing how many times people ask for it – even people who have been there for years and whom you would think know everyone – are confused and aren't sure who reports to whom and who is responsible for what? For this company, the mapping of the cost centers to the financial statements (which are actually very important to this particular company) is very time consuming – the accounting team has to go to senior management and ask where people report, and even after that, they are never quite sure they captured it correctly – they'll later learn that someone changed departments – but they weren't aware or someone forgot to tell them.

Finally, remember the 80:20 rule. The goal is to get internal cost centers approximately right, but it is usually not worth driving for precision. In most companies, people cross organizational boundaries all the time, but it's probably not worth spending a lot of time worrying about it . . . there is value in knowing that you spend $490,000 on a function, but not a lot to be gained in the extra precision that it is actually $491,625.32.

Ensuring that cost centers follow the organizational chart will greatly facilitate understanding.

CHAPTER 3.

TAXATION WITHOUT REPRESENTATION

Meaningless cost allocations can invalidate cost center reporting in the eyes of the department owner

You know, our country was founded, in part, based upon this issue! If you are in a company big enough where costs are allocated between departments, be careful about allocating costs over which people have absolutely no control. It tends to weaken the link between their actions and the financial statements – sometimes so much so that they don't feel that the financial statements for their functional area reflect their activities in a meaningful way. Over time, rather than taking ownership for the results, they dismiss them.

Moreover, think about what you are allocating – is it worthwhile and reasonable? I once walked into an engagement and took over for someone who was, quite frankly, being fired. He wasn't adding value, offered no perspective on the future direction of the business and wasn't helpful to the investors trying to move the business from a loss position to a profit. He was spending an inordinate amount of time on things that didn't matter and almost none on items that were critical. He was calculating how to allocate a $75.00 charge for payroll services every month based upon the actual number of people who were in each of five departments. Because the payroll charge varied a bit every month, and someone usually came or left, it was a new calculation and new journal entry every month! Really? Is this something that a six figure person should be spending their time on?

3. TAXATION WITHOUT REPRESENTATION

Allocate costs that matter where necessary to understand the cost of a product, department, location, etc? But don't waste time on things that don't matter.

Allocations should be accurate--but don't waste time with meaningless precision.

CHAPTER 4.

FOLLOW THE TREND

EXPOSE HIDDEN PROFITS!

4. FOLLOW THE TREND

Numbers are relative . . . one needs the context of prior periods in order to make them meaningful

Numbers are relative – a $10,000 expenditure isn't meaningful unless there is context around it – does it compare to $5,000 the prior month or $20,000 the prior month. Is it 1% of the budget for a particular category or 10%? One of the easiest ways to provide context is to show trends over time. I've gotten to the point that I will almost refuse to look at financial statements unless I can get them in a format where I have enough data to understand the trend.

Recently, I was in a financial review meeting for a new client. I had asked that everyone get an income statement by month and insisted that I get mine in advance by email. While the accounting manager emailed me the trend report, she and the outside CPA had given the rest of the management team just the current month. While the financial review process was new to this company, the executives in the room had seen the income statement and balance sheet for years, while this was one of the first times I looked at this company's numbers. Yet I was the one able to make comments about the results of the month with context and whether I thought various revenue and expense line items were "in-line" or high or low.

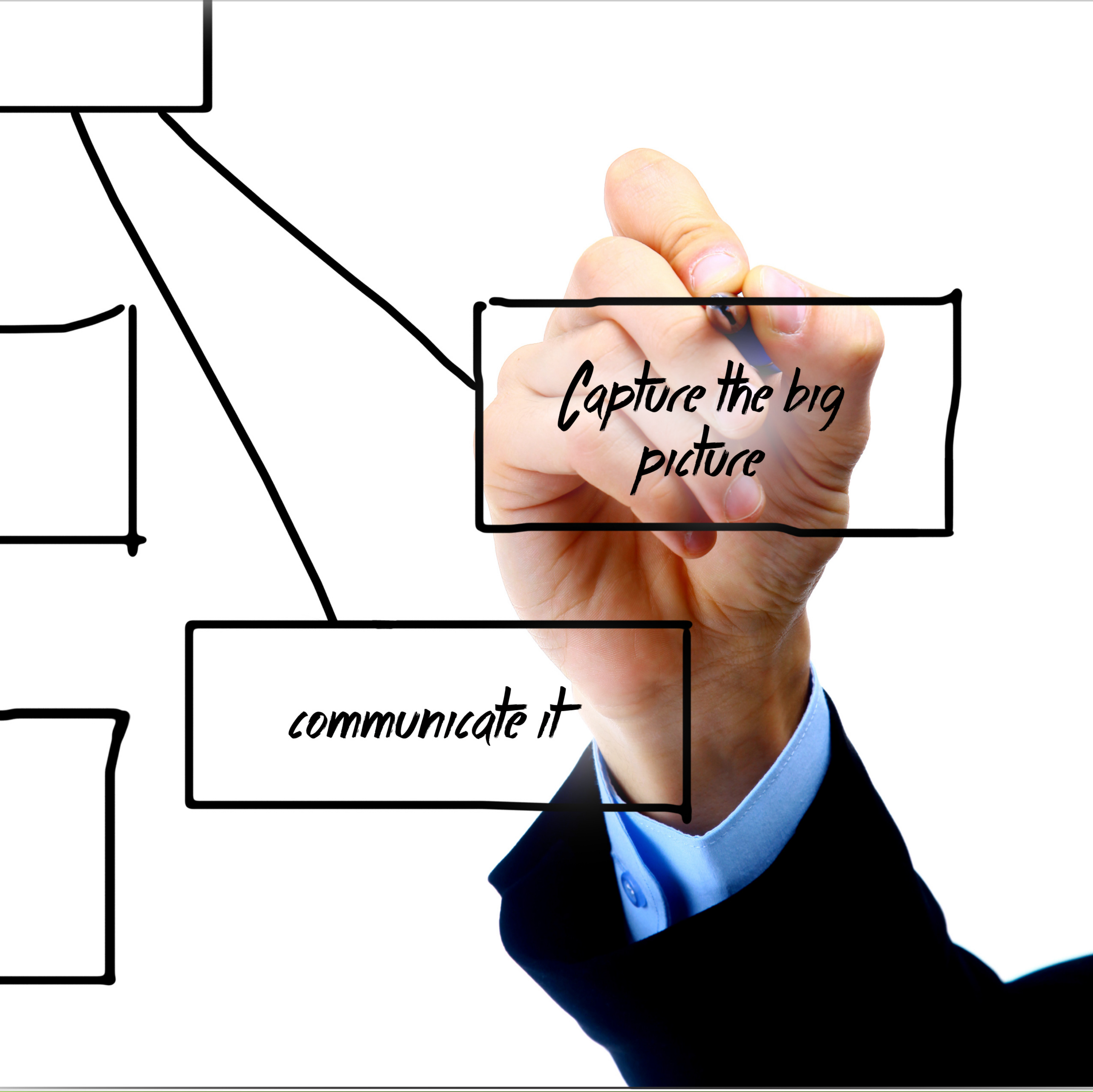
Further, because I had my report in spreadsheet form, I was able to quickly run some ratios and speak about certain items as percentage of revenue. Finally, one of the executives looked at me and said: "Ken, what do you have that I don't have?" I laughed and said, "I have the report for the trailing twelve months." He looked at the accounting manager, and said "I want that" . . . he realized that I had greater perspective than he did even though he had been with the company for years and I was a relative newcomer.

To me, the most interesting part of any trend is not so much what it says about the past, but what it says about the future. Historical trends are often good indicators of future performance! Think about how expenses and ratios are trending over time and what can you do to influence their behavior?

It's important to follow the trend.

CHAPTER 5.

WHAT ARE YOU TRYING TO TELL ME?



Paint a picture and tell your story -- literally, every page should have a written take away

Compliment your financial statements with visuals (charts and graphs) to deliver a message to the reader – not just a page filled with numbers. Why not bring some life to your financial reporting package? Have your controller, accounting manager, CFO, bookkeeper (whoever you have) develop some meaningful charts and graphs around revenue trends or revenue mix from your income statement. Why not include a chart or graph on expense trends or expense mix and how it is changing over time? Perhaps include visual statistics on gross profit margin?

Think of how your banker will react when he or she gets a financial reporting package with information that helps them understand and interpret the data. Not only should you supply a chart or graph, but have someone take the time to title it with the key point they are trying to make.

Tell the story. Here's an example: Gross margins are down 2 percentage points as the company has added incremental revenue but at a slightly lower margin. EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) has increased $30,000 per month as a result. Capture the big picture and communicate it!

Now, on the other extreme, I once walked into an engagement and a reporting package for $10 million company where every number on the page was down to the penny. First, the numbers were so small even I couldn't read them – and I'm used to reading this stuff – add to that the fact that the CEO was a big picture guy – he couldn't stand these reports. I clicked a button the accounting package and divided everything by a thousand. I also restructured the reports – now the CEO was looking at the information and was engaged – before, his eyes just glazed over. The CFO just didn't know how to tell the story!

Remember - what are you trying to tell me?

CHAPTER 6.

DON'T HIDE THE IMPORTANT STUFF

EXPOSE HIDDEN PROFITS!

Key metrics, operational reports, etc. are a meaningful component of financial reporting

As I just said, in my last chapter, every financial statement tells a story about the business – it is incumbent upon the finance team to tell that story. If profits are up, why are they up? Do the results make sense in the context of last month, last year and the budget?

But the financial statements can't tell the story by themselves – there are a variety of other key reports that are important to fully understand business performance. Make sure these are a regular part of your reporting package and make it easy for people to identify and understand them.

Consider adding key metrics so that people can get key information at a glance. Depending upon your business, billable hours, labor efficiency, on time shipment percentage, order backlog, manufacturing throughput, etc. are examples of key metrics. These are all examples of important analysis that can and should come with any reporting package – and remember the last point, take the extra time to tell people what they mean to the business.

Add special analysis where appropriate. I often add a special analysis of something that was discussed during the month – it may have come from a casual question or it may to answer a question that has lingered at the company for quite some time.

6. DON'T HIDE THE IMPORTANT STUFF

Lead people to the answer. They may disagree. But that's OK. Through that disagreement you can build a common and meaningful understanding. That means putting important information in front of people so that they can react to it.

Don't hide answers to key questions – make sure they are broadly circulated in order to facilitate a common understanding – they say "information is power" – but you can only leverage that power if you use it to help people understand the business and drive it forward.

CHAPTER 7.

MAKE IT TRANSPARENT

EXPOSE HIDDEN PROFITS!

7. MAKE IT TRANSPARENT

Company goals and results should not be a secret

Reporting should be easy to understand. The reader should be able to take away the essence of the information literally at a glance. Sometimes people only spend a few seconds reviewing a report. Think of it like a résumé. People scan a résumé in seconds looking for key bits of information (experience level, industry someone has worked in, degree, etc.). People do the same with financial reports – use color, shading, bold font, etc. to make it easy for them to find the information they need right away.

In addition to being easy to understand, there should be a broad awareness across the organization of how the company is doing. That doesn't mean you post the income statement in the hallway, but there are certain key metrics should be available for general consumption.

I had one company where goals and progress toward them were kept secret due to the fear that morale would be negatively impacted if everyone knew that the company missed the goal. Management somehow thought they were protecting the employees. In fact, what they were doing was keeping the employees from helping.

7. MAKE IT TRANSPARENT

The two years after we started broadly communicating company goals were the two most profitable years in the company's twenty year history. That's not a coincidence. Everyone knew annual sales and profit goals and worked hard to hit them. We saw administrative people taking on more work so that sales people had more time in front of customers.

We also saw them watching costs more closely. Everyone knew that if the company made its goals there'd be bonuses distributed at year end and literally everyone would have some share in it . . . it drove the organization.

Be honest about company performance . . .
transparency can be a very powerful tool.

CHAPTER 8.

DECOMPLEXIFY

8. DECOMPLEXIFY

Simple is almost always better . . . why do we make things more complex than they need to be?

Many accounting and financial reporting processes are just far too complex and while in some companies there is far too little information available, in others there can be far too much.

In one large company, I was given the responsibility for rationalizing a large body of reports the accounting team was creating. My staff gathered and was ready to provide input on how to proceed – they had lots of recommendations. They were surprised by my unusually relaxed approach to the job at hand. I listened patiently until they finally asked me for my recommendation on fixing and rationalizing the reports – "What should we do?" they asked. My response was that we were going to "do nothing". I'm going to tell to them to stop running the entire set of reports. "What if someone asks for one of the reports?", was the question. "Then we'll produce it!", I said.

I knew that almost everything on the list had outlived its usefulness a long time ago – the right answer was to just quit producing most of it – we took a tremendous amount of work out of the system with no negative result. Not only should you cut out unnecessary tasks, activities, reports, etc. but you should strive to simplify those that you keep.

The key is to ask "why?" when evaluating each and every step in the process. If someone doesn't understand the "why" they are doing something, then they are just going through the motions and have no opportunity to add value to the process. You don't need people going through the motions – you need people adding value!

I almost always choose a simple process over a more complex one. It is quicker, can be easily understood by more people, and is easier to automate.

Remember, decomplexify!

CHAPTER 9.

REMEMBER TO SHARE

9. REMEMBER TO SHARE

Information is power. . . but the organization cannot leverage that power in a culture of "keeping it to myself"

Most of us learned in kindergarten the importance of sharing. But somehow we forget that lesson when it comes to important information in our companies. Share information to the greatest extent possible. Now, obviously some things are confidential and on a "need to know" basis. But don't hide valuable business information that should be available to key leaders.

Information belongs to the organization, not to the individual who happened to create it. It's only through widely distributing key information that people can understand the status of the business and help be part of the solutions.

A company I recently consulted, has an accounting team that simply refuses to share information with those that need it. While I understand their need to control the process of creating information, I am amazed by their unwillingness to share important information and to be helpful to others in the organization. The result is that people find ways of going around them in order to get the information that they need to do their job.

Rather than being viewed as a business partner – they are generally viewed as being obstructionist – and while they handle a high volume of work – they appear inefficient to the rest of the organization.

Sharing information across the organization spreads knowledge and fosters teamwork and collaboration --- it enlists everyone in working toward a common goal. It is also an excellent training tool that helps more junior people understand the perspective of executive management.

Here's what I suggest. Share what you know – you might just find other people starting to share with you!

CHAPTER 10.

SEEK INPUT / GIVE INPUT

Transfer knowledge . . . both inside and outside the organization

Find out what unanswered questions there are in your organization. What do people want to know but don't have a way of understanding? Then work together as a team to answer the question. Seek input from outsiders – there is almost always someone who has dealt with a similar question before and they can often help.

One way in which I deliver value to my clients, is that I bring experience from multiple companies and engagements. There have literally been times when I am working on very similar problems for two clients during the same month. There is tremendous leverage in being able to port the knowledge of how to solve a similar problem between companies.

Ask a colleague (another business owner, for example) to see how they use financial reporting. Learn from others. Once you've gotten input, make sure that the information you are presenting does an outstanding job of answering the question at hand.

10. SEEK INPUT / GIVE INPUT

Whether you are on the receiving side or the producing side of information, make sure that there is clarity with respect to what question various reports are trying to answer. Have conversations about the business – don't assume that information is understood without periodic discussions.

Without a doubt, there will be something gained from conversations about the business between the finance team and others in the organization – don't waste the opprotuntiy to have transfer of knowledge.

The best leaders seek input from a variety of sources…and are also willing to share their knowledge.

CHAPTER 11.

COMMIT IT TO WRITING

Crystalize thinking, create accountability, understand your progress over time!

I know it takes time to commit thoughts and ideas to written form but it is well worth the effort. You will find that through that process, you crystallize your own thinking and deliver a sharper and more precise message than you would have if you had just tried to discuss an issue without prior preparation. Not only does it create accountability but it is a record of how your own thinking may have advanced and evolved over time. That is an incredibly powerful tool to have when you look back over a year or so and realize how much better you understand your business compared to the past.

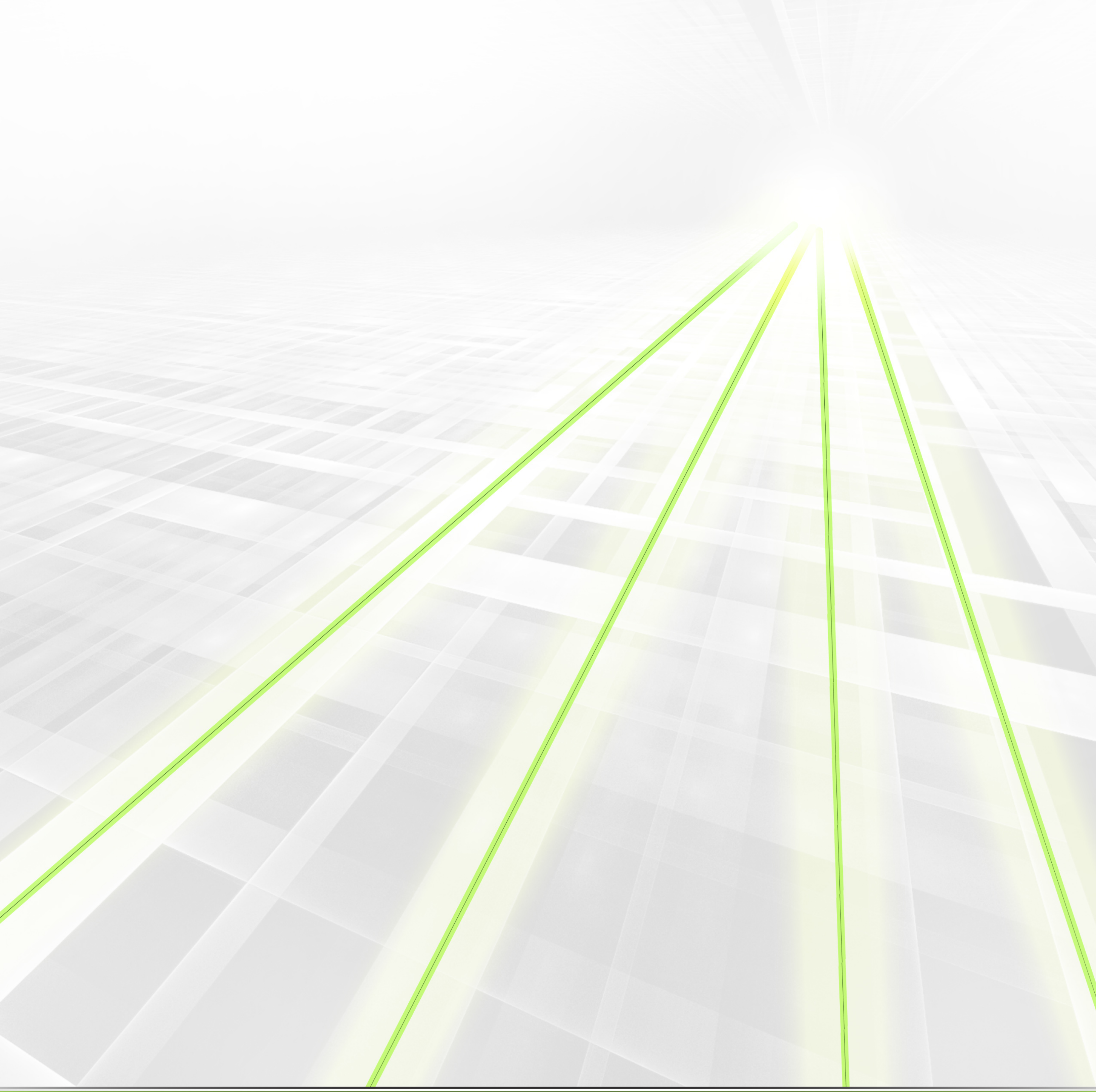
Recently, we were trying to sort through the financial results of a division where the financial reports had been produced incorrectly for the past year. Within just a few days of being engaged, I committed to the executive team, in an email, my preliminary thoughts about where the results would end up for the year.

After more than a month of grappling with the issue, results came in substantially better than my early estimate – although not nearly so good as had been suggested by the inaccurate reporting that had been circulated prior to my being engaged. In the final wrap up, however, I was able to relate the current results to what I thought during the first week and discuss them in light of two key facts that came to light during the intervening period.

Unless those initial thoughts had been committed to writing, they would likely have been lost in the flurry of information and conversations that transpired subsequent to that projection. For me, documenting your thinking over time allows you to understand how it has evolved and that shows progress. That progress is what fuels my personal desire to continue moving forward.

A written record will allow you to see how your thinking has evolved.

CHAPTER 12.
LASER FOCUS



EXPOSE HIDDEN PROFITS!

12. LASER FOCUS

A handful of key objectives people can remember is more powerful than twenty that are stuck in a drawer

People can only focus on a limited number of key goals and objectives. A handful of key objectives that people can remember is more powerful than dozens that people forget.

They say, if you try to focus on everything, you will focus on nothing. Pick no more than a handful of key metrics by which you will measure the success of the organization over the coming year and share those widely with everyone in the firm reporting on progress regularly – not at the end of the year when you will have either made your goals or not – but along the way so that people can drive for results.

I once had a client who expressed so many ideas to the organization that they referred to it as "idea soup". The CEO was incredibly creative but the organization stopped responding to him – there were literally times that he would come back from lunch with different ideas and directions than what he had discussed in the morning. The result was that the organization had so many tasks, initiatives and objectives, that they were always starting on something new and never getting anything across the finish line. They had no focus – therefore, despite a great amount of activity, little was actually accomplished.

Pick key goals and objectives, focus on them, and drive them to completion.

CONCLUSION

I hope you have enjoyed "Expose Hidden Profits: How to reach greater profitability through financial insights"

And I hope that you have been inspired to gain a better understanding of your financial statements and, more importantly, drive for higher levels of profitability.

Understanding your business through the numbers is critical to your success. Don't be intimidated by your financial statements and don't be afraid to ask questions. You'll be amazed at how much you can learn about your business and how much more successful you can be by focusing on this critical component.

Learn more with my book

YOUR CASH IS FLOWING:
WHY EVERY ENTREPRENEUR NEEDS TO THINK LIKE A CFO

available at **www.YourCashIsFlowing.com** and at **www.homza.com**

Homza's outstanding leadership as a fractional CFO has brought significant financial strength to a broad spectrum of companies where his guidance and expertise allow his clients to focus on core business issues.

Ken's experience spans large, billion dollar corporations, mid-range companies and start-up ventures in technology, manufacturing, distribution, retail and service delivery organizations. His résumé includes successful tenures at Unisys and LensCrafters where he served in finance, marketing and strategic roles.

ABOUT THE AUTHOR

Ken is a financial steward who brings a "spend it like it's your own" approach and has served over 30 clients in various phases of development across multiple industries since 2003. His guidance and expertise cause business owners to have a better understanding of their financial position and improved bottom line results.

For new businesses, he applies his critical thinking to the issues faced during the start-up phase. For more mature businesses, he helps them to better understand their financial results through key performance metrics and financial planning and forecasting while he focuses the executive team on actions to improve profitability. One of the key tenets of Ken's approach is to get to the facts. He believes a better outcome always results from a clear understanding of the actual operating environment as opposed to assumptions and hearsay.

Results have included finding six figure savings in a matter of weeks, seven-figure profit improvements from year to year, and complete business transformations.

He has worked on both sides of the acquisition table, helped two clients through the difficult process of Chapter 11, and served in the dual role of CFO/CEO for a company facing multiple challenges leading it to a successful sale within 15 months of taking the helm.

In addition to serving his clients, Ken has served on various not-for-profit boards and has spoken on finance, strategy and start-up issues in front of business leaders and at the university level.

Ken holds an MBA from the Carnegie Mellon University Tepper School of Business. He and his family reside in University City, Missouri.

Learn more about Ken's unique approach at
www.homza.com