

The 3 Step Financial Makeover

Todd Rammler, CMA, MSA
“The Small-Business CFO”

It was around 7:30 p.m. on a Wednesday evening in April when my cell phone rang. It was Matt, a business owner I had talked to a few times at networking events around town. He was concerned. Earlier in the day he attended a quarterly financial review with his banker, and the banker did not react well to Matt’s financial statements.

“The banker was asking all these questions, and I didn’t know the answers. I’m an engineer, not an accountant!” Matt said.

Matt’s company hit a bump in the road, and had lost money during the previous 15 months. But what concerned the banker were not necessarily the losses, but the lack of understanding as to what was causing the losses and what was being done to correct the situation.

Two months later, Matt’s company was being pushed out of the bank.

At that point Matt asked for my assistance with this situation. When I first looked at Matt’s financial statements, I wasn’t surprised at the banker’s reaction. The statements were a mess. There were errors, conflicting reports and omissions.

We spent some time reconfiguring Matt’s financial statements, creating a consistent month-end process, training Matt and his staff on these changes, and implementing cost cutting strategies. We put tools in place to track performance and set objectives for the end of the year.

In 3 months, Matt went from a \$300,000 loss to breakeven. By the end of the year, he made a modest profit.

The next year he experienced record profitability. Six months into the current year, he’s already exceeded his profit from all of last year.

Welcome to extreme makeover, finance edition!

Important Note: This chapter is not about the usual financial topics – tax strategies, financing alternatives, how to hire a CPA, etc. *This chapter is about making money.*

Specifically, it's about using the data you have to make better decisions . . . to make more money. It's a rare glimpse into the thought process of an experienced CFO.

My firm provides outsourced CFO (Chief Financial Officer) and Controller services to small-businesses. In this chapter, I will outline the process we go through when we accept a new client—and the same process we went through with Matt's business. The specifics may vary from client to client, but the overall process is the same. Our objective is simple: use the data to maximize profitability. We follow a proven 3 Step Process. Here's an overview:

The 3 Step Financial Makeover Process:

Step #1: Organize the past

Step #2: Understand the present

Step #3: Create the future

Let's get started. . .

Step #1: Organize the Past -- Format Financial Reports to make analysis EASY

It is impossible to make effective business decisions if your data is not organized properly. I've been a professional accountant, Controller, Finance Director, CFO for 15 years. My main focus has always been financial analysis – not tax returns, not audits, not GAAP (Generally Accepted Accounting Principles) compliance, not treasury – just financial statement analysis.

I'm continually amazed at the financial reports business owners use to make decisions. When I meet a prospective client, I ask to see their existing internal financial statements. In most cases they produce a document that is 3-5 pages long (per statement) showing current period information and possibly year-to-date or prior year data as well. I look at it and I see a bunch of numbers. But they're not organized in a fashion that is telling me anything.

Look, accounting is complicated. debits, credits, GAAP, tax, accruals, reserves—it's enough to make your head spin. Unfortunately, it has to be complicated. But our objective is to take this complicated mess of numbers and organize them so that they create a picture. For the average business owner, it's like a puzzle that just fell on the floor – pieces everywhere, and just the thought of trying to sort it all out is overwhelming. However, if we build the financial reports properly, those pieces come together to create a picture that communicates a clear message.

I am a big believer in the KISS principle (Keep It Simple, Stupid). I'd like to share with you two of my KISS principles regarding financial statements:

KISS Principle #1: If your financial statement cannot fit on one page, it's too long.

No exceptions. Now if you want to use an 11 x 17 paper, that's up to you. But I have a strict one-page limit.

KISS Principle #2: If I can't understand your financial statements, you can't either.

By "understand", I mean being able to quickly find problems, see relationships, and draw meaningful conclusions.

After a prospective client has shown me their internal financial statements, I then show them a sample set of our *TRENDSPOTTER* financial statements laid out the way I would do it for them.

They all switch to this format.

Now, I could attempt to explain to you the specifics of how we put together financial statements, but as the saying goes, a picture is worth a thousand words. At the end of this chapter there are instructions on how you can get a copy of sample *TRENDSPOTTER* financial statements that are organized for analysis. This will provide you with an excellent starting point.

Some additional tips for creating financial statements that allow you to do analysis like a pro:

- Segregate different types of revenue into 2-4 main categories
- Segregate major direct costs (labor, material, subcontractors) into these same categories. These costs will be considered "variable" costs. There should be a fairly predictable relationship between these costs and the corresponding revenue line (e.g., labor is expected to be X% of sales, etc.)
- Create logical subgroups in order to condense the statement into 1 page. For example: rent, utilities, property taxes, trash removal can all be grouped on a line item called "Facilities Costs". If more detail is needed we go to other reports; but let's start with the 500 ft view, looking at the forest, not the trees.

- Similarly, don't show line items that contain minutia. Group any oddball costs together under "Miscellaneous" or some such appropriate heading. If you're a \$5M dollar business, you don't need to see \$50 for postage as a separate line item on your P&L. It's not relevant.
- Eliminate clutter – No pennies, no dollar signs.
- Create "dashboards" for the handful of items that are the keys to driving your profitability, cash management, etc.

Step #2: Understand the present -- What is the data telling you?

"Financial analysis" is a boring, overused, vague term that can send people running for their pillow & blanket. But in the context of running a business, it is one of the most important things to understand, assuming you want to maximize profitability.

The objective of financial analysis is to understand what the data is saying, and make effective business decisions that maximize profitability, minimize risk, and protect company assets.

In laymen's terms, it means using the data to make more money.

To accomplish this, we begin with the one-page, TRENDSPOTTER financial statements described earlier. Using this type of statement we can tell if the key relationships for your business are out of line, and investigate those items further. Problems will jump off the page, such as:

- Costs posted to the wrong period
- Costs that have been missed (not posted)
- Cost posted to the wrong accounts (mis-posted)
- Jobs/Projects/Products whose margins are eroding, increasing, or contain errors.

We can also use this type of report to make important decisions relating to:

- Price increases
- Cost cutting
- Expansion
- Elimination of certain products or services

We'll be able to quickly calculate the breakeven sales level, or the amount of sales needed to generate 5, 10 or 15% profit. We'll be able to predict profitability for any given level of sales.

As you progress through the analysis step of the makeover process, it is quite common to have different systems or different components within the same system giving you conflicting information.

Financial analysis helps us find these types of issues and fix them. All your numbers, reports, and management information should be in harmony providing you with a clear and consistent message. Unfortunately, this is frequently not the case. Lacking the proper expertise internally, many business owners choose to ignore it and "hope everything works out" by the end of the month/quarter/year.

But hope is not a business strategy.

There is no substitute for accurate financial analysis.

Step #3: Create the Future – Projections become Reality

If you've ever listened to Zig Ziglar discuss goal setting – or done any homework on it at all – you know this: Goals that get written down are much more likely to be achieved.

If it is common knowledge that writing down goals is the proven, accepted way to achieve them, why not create written financial projections?

Four Lame Excuses for not having written financial projections:

1. We've always wanted to do it, but just haven't gotten around to it
2. We don't really know how
3. Our sales are unpredictable, so it's a waste of time
4. We've managed to get by for 10/20/30 years without them, so why start now?

Note that these are excuses that the average business owner would not tolerate from an employee. Try to imagine this conversation:

Business Owner: "Jack, I need you to put together a timeline for the ABC project to see if we'll meet the timing and budget requirements."

Jack: “Boss, we’ve managed to get by for 20 years without a timeline, so why start now?”

Business Owner: “Jack. . . . *you’re fired.*”

Look, it is human nature to procrastinate, to avoid tasks that we’re not sure how to do, and to get caught in “That’s the way we’ve always done it” thinking. And I know business owners are busy and are constantly pulled in many different directions. But this is important! If you don’t have the time or knowledge, find someone who does and get it done.

Projections do not need to be precise to be useful. Doug Hicks, author of “*ABC for Small and Mid-Size Businesses*” and an expert in financial modeling and Activity Based Costing puts it this way: “It’s better to be *approximately* right than *precisely* wrong.”

The objective is to put together a projection based on our best estimates and refine the estimates as new and better information becomes available. That way we’ve created a target, and we can make adjustments in order to hit the target – or change the target – or both. But without the target, we’re playing blind archery.

If we have the projections in place and they are kept up, we can see future problems as well as opportunities that are coming at us, and make decisions on how to react to those problems or opportunities. Just because you’ve been successful for 30 years without projections doesn’t mean you shouldn’t do them. Things change. Ask anyone who’s a supplier to the auto industry. What may have worked 30 years ago, will not necessarily work today. Furthermore, I can make a strong case that choosing to ignore this discipline is almost certain to result in leaving money on the table.

The 3 Step Process I’ve just taken you through is intended to bring clarity to the past, a tighter focus on the present, and visibility for the future.

If you have competent help, and can implement the 3 Step Financial Makeover outlined in this chapter you should be well on your way to achieving the 30 Day Total Business Makeover, and realizing the profitability goals you’ve set for your business.

About The Author:

Todd Rammler, CMA, MSA is the President of Michigan CFO Associates, a leading provider of outsourced CFO and Controller services to privately held businesses. For more information please visit www.michiganCFO.com or call (586) 675-7605.

To get a copy of the whitepaper The #1 Financial Mistake Made by Small-Business Owners, please visit www.michiganCFO.com/freereport.

To receive sample TRENDSPOTTER financial statement layouts, send an email to info@michiganCFO.com and type “TRENDSPOTTER” on the subject line.