



Cash Flow Flags

How could this happen?

It must have been the economy!

Let me tell you the story of a business that was founded over 50 years ago. They were a family furniture operation that had grown from a small mom and pop shop to an organization that operated three stores and did \$10 million in sales. Times were good—for a while. Last year they declared bankruptcy and closed their doors.

by David McMahon

The slowing economy, as in many cases like this, was only one factor. In fact, in this case there was only a modest sales decline relative to similar businesses. The primary factor for their demise was an outright failure to be a student of their business.

Their family had grown so there were more people to support. Between the various brothers, sisters, sons, daughters, and cousins, there were multiple people who relied on the business to pay for their mortgages and feed their families. On top of this, there was no clear leader. Every decision had to go through a sort of unanimous voting process. This slowed their speed to react and innovate. And the decisions that were made were often times on issues that were not of any great benefit to the business. They wasted time. It got so bad that there was one argument amongst the brothers and sisters on who was supposed to put the toilet paper in the bathrooms! They had little time to focus on what counted. They only tracked

written sales. All the other critical measures were ignored.

Eventually they decided to take on debt to finance their growing accounts payable. They tried mass event sales to blow out their inventory. They were just able to break even. They repeated this strategy of refinancing debt and big event sales. Eventually they became insolvent. This meant that they could not pay for their short term obligations. Minimal profitability, missing sales goals, and rising debt put the nail in their coffin. Bankrupt.

Unfortunately, stories like this are far too common. If this company had a leader and a team who knew what red flags to look for and took action soon enough, they would have survived. In this article I'm going to show you the red flags to look for. If you keep your eyes on these, you will greatly improve your chances of success and you will be able to take corrective measures sooner. With you as a decisive leader of your capable team, your cash flow potential can be maximized.

❶ **Sales to Plan.** Sales drive everything. Your plan is your realistic projection of sales or your budget. It is also the dollar amount needed to produce your required profitability and cash flow. To calculate this, take your actual monthly sales and divide by monthly sales on your budget (your profit plan). For example, if sales were \$550,000 and planned sales were \$525,000, then sales to plan is 105 percent. This should be checked monthly, quarterly, and year-to-date each month. Repeated underperformance of sales to plan (under 100 percent) signifies either performance issues with sales or a budget that needs to be adjusted in its entirety.

❷ **Profitability.** This is the ultimate source of all cash. It is sales minus all your expenses. To view as a percent, divide that number by sales. No operation can operate with a loss for very long and few can operate at average profitability (2-4 percent) and grow their business. Alternatively, healthy profitability (7 percent+) enables growth through reinvestment of equity into the business. This investment leads to expansion and takes the form of technology, training, capital investment, merchandise lines, and human talent. Paying out all the profit to shareholders does little for the future of business. It is important to note that profitability needs to be consistent to really make a difference. It should be checked each month on certifiably correct financials both for the month and year-to-date.

❸ **Quick Ratio.** Also called the acid test ratio. It is a measure of the liquidity that you have in your business. It is calculated by taking your current assets, less your inventory, divided by your current liabilities. An even ratio of 1 is solid. Anything under .5 means your business may be in a danger area. Companies with very low quick ratios are at risk of insolvency.

❹ **Cash to Current Payables.** This measures your ability to pay for your immediate responsibilities. It largely indicates whether you can honor your short term loans from your vendors. The importance of this is critical to continue uninterrupted flow of goods. Many companies in the last few years have shut their doors because their vendors simply stopped shipping. Track this monthly and seek to be consistently above 25 percent. Anyone under 15 percent is probably struggling to make ends meet and are most likely dipping into lines of credit.

❺ **GMROI.** Gross margin return on inventory. All your cash comes from selling inventory, right? And if you sell your inventory faster or carry less of it, you generate cash faster, right? That's what GMROI is—the ultimate measure of your operations effectiveness at creating dollars! Figure this by annualizing your gross margin dollars and dividing by your average or current inventory on hand. Do it every month without fail. Seek to continually improve this number overall. I call a \$2 GMROI a break even GMROI and a \$2.5+ GMROI an “in the money” GMROI.

SALES PROFITS RATIOS MARGINS
PAYABLES CASH ROI INVENTORY



Red Flags:

Be ready to weather the storm



6 Inventory to Sales. This flag is your key to controlling new buying. Purchasing should follow sales results or realistic forecasts. You all know what could happen if you go to market and you buy without a plan. Only a certain percent of the new merchandise sells; the rest sits in stagnation. Obviously, invoices become due for that inventory whether it sells or not. Timing and the amount you spend on new merchandise is everything. In fact, most of the businesses that have gone out in the last few years were overbought when the economy was good. That's why they could not weather the storm. Figure your inventory to sales by taking your average or current inventory that is in your possession and divide it by your annualized sales. I've been in the analyzing and advising business for over a decade and have never seen a profitable and growing business operate consistently above 20 percent. I call 15-17 percent the "sweet spot". Faster turning categories such as bedding or appliances can be even less. Only purchase new merchandise if inventory to sales is in the "sweet spot" range.

7 Gross Margin. How much money do you have left to pay for all operating costs and make a healthy profit after you deduct your cost of goods and freight from the sale of your merchandise? That is your gross margin. Figure as a percent each month and year-to-date by dividing by your sales. In retail furniture and bedding, most operations have two options, in my opinion: be above 46 percent or below 42 percent. The reason relates to sales volume and turns. There is just very little economies of scale with small and medium sized businesses. Fixed operating costs can eat profits unless the margin is appropriate. Unless you have a killer deal on rent and a great location, a store doing under \$5 million will find it difficult to operate at under 46 percent margin on their financial statements. Alternatively, for example, a store with sales of over \$20 million could operate at a lower margin and be a low cost seller and still be decently profitable. Below is profit matrix of where cash is typically made with respect to gross margin and turns. Avoid the "death zone".

Profit Matrix	Low Gross Margin	High Gross Margin
High Turns	"Profit potential"	"Hugely profitable"
Low Turns	"Death zone"	"Profit potential"

8 Operating Costs. These are all the costs that you incur each month after your cost of goods. You should set target percentages of sales by department in your master budget so that you can avoid expense profit erosion. The commonly tracked departments in your operating budget are: administration, occupancy, selling, marketing, service, warehouse, delivery, and finance. Overall high profit operations seek to be under 38 percent.

Be a student of your business. Watch for the red flags. That is the first step on your road to achieving a healthier cash flow position. It is the first step in giving your business longevity whatever your sales volume is. It is difficult to improve what you don't track so doing this will help. The next step is to take the right decisive actions at the right time. **W**

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