Performance Management
Best Practices – Part 3 (3 of 4)

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Financial Value – How to Measure and Manage in Real Time.

This is the third in a series of 4 articles on performance management. Our goal with this series is to provide businesses with a simple approach to adopting a performance management system.

As a CPA in public practice, you might think that this is an old hat. Sure, it's easy to develop financial measures after the end of a fiscal period. By that time, it doesn't matter to the business owner. He or she has already looked forward to the New Year and what prospects it holds. What is not so easy is trying to develop financial reporting systems that provide us real time information. We cannot ignore the financial part of our business and allow for dated financial statements to be our only measure of financial health.

Let me share a quick story with some analysis. You have heard of a little company called Wal-Mart. I have a soon to be relative that works as a Department Manager at Wal-Mart. I was on the phone on the eve of Thanksgiving with this young lady, discussing how these tough economic times of 2008 were affecting her store. Her response, without hesitation, was that when she left the store, her store was up 28% in sales over a year ago. First of all, I was surprised at the increase since this store was not a new store in a mature market in Illinois. However, what really struck me was that she knew up to the day, and maybe even the minute, what that store's performance was over a year ago. So my question to all small businesses out there is this: How many of you share financial results with your employees? Better yet, how many small business owners share their financial goals with employees? Let's assume that not many of us do. So if we expect to achieve our financial goals, wouldn't we increase our chances of success if we had more people working toward the same goal, monitoring our progress, and trying to improve upon results to achieve those goals?

In the first two articles, we discuss human capital and market share – employees and customers. Now we want to focus on another critical driver, the financial management system. There are really 3 areas of financial management that have to be a part of any good performance management system.

As the old saying goes, "no margin, no mission". If we aren't creating value, we are really wasting our time in business. One way to create value is to increase cash flow. This is our first area of focus – monitoring cash flow. We have to have cash to operate our business, and as we live through this financial crisis in 2009, we are reminded of the importance of cash. We must monitor what is driving our cash inflows and our cash outflows and those activities need to become part of our management dashboard. I recently hired a plumber to come to our house, and then on a separate occasion, an electrician. The plumber provided the services needed to fix our problem and promptly computed an amount due, and presented an invoice to my wife, which she immediately paid. The electrician billed us 6 weeks after the service was performed. In this little example, the key activities to monitor are the amount of billings sent out daily, and the amount of unbilled work on a daily basis. Unbilled work is like inventory. Every day it sits it is costing you money. So what are those key cash flow drivers in our business? We have to monitor activities that involve the delivery of product or service, and the collection of cash for those completed transactions. This may involve billing, accounts receivable collections, or progress billing. Secondly, what is consuming cash and how can we slow the consumption of cash? This involves monitoring your inventory turns and your ordering process to ensure you don't tie up too much cash in inventory. It may also involve negotiating better terms with vendors to extend payments. Cash is also consumed by debt payments or capital expenditures and we have to plan for these needs and ensure that our cash flow is adequate to cover these needs.

We also create enterprise value by increasing our sales and our net income. We should always look to grow sales, but it has to be profitable sales. One of the biggest issues we see in a business is that they don't understand their true costs of doing business. Fully absorbing costs to a product or a service or a project is not commonly done. As a part of our performance management system, one metric we need to know is our break-even point. At the end of the day, how much in sales do we need to achieve to break even? This can be a little bit of an intimidating number. Knowing every day, you have to sell so much product or service at a certain margin, just to break-even. So to do this, we need to create simple systems to report our profit margin – and I would recommend this is reported out to other employees. We should also have goals. From a financial reporting standpoint, goals are communicated in the form of a budget. If we hold ourselves accountable to a budget, we will improve our chances of increasing enterprise value.

The final area to discuss is data integrity. You have to create a financial management system that ensures accurate financial data is being reported and that there are adequate controls and reconciliations that are being performed. In a small business, the internal control may be your detailed review of the financial information and the detail behind the information. You have to build a system that mitigates errors and potential fraud. If you don't, you need to be prepared for a surprise.

In summary, I always tell business owners that they need to be prepared to sell their business at any point in time. Life changes, and sometimes unexpectedly, so we should always plan. To do that, we have to focus on improving the enterprise value and focusing on our financial indicators. Again, my focus is on 3 areas of the financial arm of your performance management system:

- Determine what is driving cash flow, and develop metrics to monitor these cash flow drivers on a daily/weekly/monthly basis
- Long-term value is built by building earnings – monitoring your sales, your profit margin, and your break-even point are going to help you build profitability
- Build systems to ensure information integrity – make sure your financial information is right and there aren't major fraud risks.

Remember, performance management systems are designed to help you plan your future successes, and the financial well-being is certainly an important focus.

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