What Should I Measure?

How to know when it's time to tighten your belt

BROTEMARKLE, DAVIS & CO. LLP

Putting People First

Measure for success.

If you have ever tried to diet, you know how important measurements are in the battle to lose or gain weight. Successful diets require that you diligently measure inputs, outputs, and ultimately, the results. And being able to monitor your progress on a regular basis is one key to staying motivated so that you can eventually achieve your long term goal.

Business owners are equally impacted by measurements. Successful businesses must stay on top of what comes into the business and what goes out, and they need timely information about where they stand at any point in time. Good financial measurements provided on a timely basis can help everyone in the organization stay focused and motivated so the organization can achieve its long term goals.

Waistline, top-line, or bottom line?

In dieting, it starts with a goal. Do you want to lose or gain weight? Once you decide that your goal is to lose weight, you can determine the desired results and then determine which parts of the equation you will attack first. Will you reduce what you consume or increase what you burn? Or maybe it will be a combination of both. But typically you look at measuring your results based on one or all of these three measures: waistline, weight, and body mass index.

Business is the same way. First, you identify a goal. If your goal is to increase the long term value of your business, just like a motivated dieter, you have a number of ways to achieve that objective. Will you increase revenues (the top-line) or focus on reducing costs as a way to improve net income (the bottom line)? Will you try to increase your collection activities to improve cash or focus on efficiencies in paying your vendors? And then there is long term value as represented by equity.

"The 2nd day of a diet is always easier than the 1st. By the 2nd day you're off it."

Jackie Gleason

Sometimes it so hard to figure out what to measure, count, or limit that you just give up, but it doesn't have to be that difficult. Like a personal trainer for business, we're going to walk you through the process by looking at each stage separately. We'll start by looking at the fuel that you need to get going, then we'll talk about how you burn it, and finally we'll talk about measuring the results of your efforts.

Fill 'er up.

Low fat versus low carb, revenue versus cash

First, you have to figure out the right kind of fuel for your body. Some diets advise you to eat low fat foods, so you measure fats—both saturated and unsaturated. Other diets focus on low carbohydrates, so you have to read the Twinkie box to learn out about carbs, sugars, and fiber (Note: To date, the Twinkie Diet hasn't shown much success). Still others would have you count calories using a point system. Regardless of which method you choose, you must still pay attention to your overall health. If you choose a low fat diet, for example, you must be sure to also have adequate protein intake or you could end up burning muscle mass. *There are risks inherent in diets that focus on just one side of the equation.*

When you think about the basic inflows that give a business the energy to operate, it comes down to revenue and cash. But just like those one-sided diets, you can't focus on just one or the other. Yes, you want to drive revenue growth year over year, but not if it means extending credit to new customers who can't pay. And you want to maintain a healthy cash position for the business, but not if it means limiting investments in strategic assets. In fact, both revenue and cash could be considered life-giving nutrients for a healthy business and both need to be monitored on a regular basis.

"I went on a diet, swore off drinking and heavy eating, and in fourteen days I had lost exactly two weeks."
Joe E. Lewis

"At the end of every diet, the path curves back to the trough."
Mason Cooley

"Diet cures more than the doctor."
Maxim

Feel the burn.
Repetitions or weight, variable or fixed costs

Once you succeed in choosing an intake measurement system, your next challenge is to measure your outputs, or the way you will burn calories. That means you must get a handle on your exercise efforts, which leads to a whole new list of questions. Do I need to keep track of repetitions, heart rate, or pounds of resistance? And how often should I do each exercise? In most exercise programs, it usually comes down to building more muscle mass and expending more calories than you take in.

If you set out to cut costs in your business, you need to decide where to focus. You can look at fixed costs, like building rent or other overhead costs, or focus on variable costs that are tied directly to the volume of goods you produce. You might look at becoming more productive through automation or by letting each member of your staff carry more weight. But just like those exercise programs, your main consideration needs to be keeping expenses proportional to the revenue you produce.

Quantify your results.
Pounds versus inches, net income versus operating cash

Once you figure out the inputs and outputs, you are ready to decide what success looks like. Now you have a new dilemma. Should I look for improved muscle mass, looser fitting clothes, an improved BMI (body mass index), or just fewer pounds? Most dieters look only at the bottom line—the number of pounds lost—which might not be the best indicator of diet success. If you are dieting for health reasons, for example, your cholesterol level might me a more important measurement than total pounds lost. And if you get too focused on a short term diet goal—like looking good for that high school reunion—you

"I have a great diet. You're allowed to eat anything you want, but you must eat it with naked fat people."
Ed Bluestone

" Don't dig your grave with your own knife and fork."
English Proverb

"Your stomach shouldn't be a waist basket."
Author Unknown

might be tempted to go on a fad diet that doesn't help you keep the weight off long term and isn't necessarily good for your overall health. The best measures are the ones that support your unique goal.

Rather than staying focused on their waistline, business owners are preoccupied with growing their bottom line. In business as in dieting, there are plenty of ways to measure success and just as many ways to evaluate progress along the way. And while it is important for an owner to keep an eye on the bottom line, there are other important financial measures that impact the success of a business. In addition to the traditional bottom line or net income, a business needs to evaluate its operating cash and its return on assets. Just like diet results, financial results need to be considered with an eye towards the overall health of the business. There is no single "magic metric" that applies for every business, but rather there are different measures that are appropriate for different goals.

Diet—three ways to measure success

	Weight	Waistline	Body Mass Index
Inputs	Calories	Carbohydrates	Protein
Outputs	Calories burned	Targeted exercises—resistance	Overall resistance workout—or yoga
Net	Weight gain or loss	Inches added or subtracted	Increase or decrease in BMI

Business—triple bottom lines

	Net Income	Operating Cash Flow	Return on Assets
Inputs	Revenue	Cash receipts from operations	Net profit divided by
Outputs	Expenses	Cash disbursed on operations	Average assets
Net	Net Income	Net increase /decrease in operating cash	Net return on assets

Business fitness

As we've noted, dieting is more than just pounds lost; healthy dieting requires a balance between how you eat and the calories you burn. Likewise, a healthy business is one that maintains a sense of balance. It is a business in which expenses are proportionate to the revenue generated, while cash received exceeds cash spent. Short term objectives are designed to support long term objectives and results are shared widely and often with employees and staff. It is a business in which responsibility for the inputs, outputs, and results are shared equally among team members, and rewards are tied to measurements.

Here's a suggested business workout to help you achieve optimal financial health.

Step 1: Look at what's coming in.

Just like those fad diets that would have you focus solely on what you eat to control your weight, there are experts who advise business people to spend most of their time and attention on sales. And while this isn't the only type of measurement that matters, business owners know their business can't survive without ample sources of revenues to keep them afloat. But revenues without cash can't sustain a business for long, so it is important to monitor both revenue and cash to keep your business healthy.

Revenue

To remain in business, you have to generate sales. But many businesses mistakenly focus all of their attention on constant growth of that top-line revenue figure. They seek to add new customers at an increasingly higher cost and often neglect other areas of the business. At some point, sales are made to customers who are not able to pay, which then makes cash the most important measure of success.

Top 10 Signs You Might Not be Measuring the Right Things.

1. Everyone in the company earned a bonus this year, and you plan to lay them all off.
2. You have money in the bank but no sales.
3. You have hit all of your sales targets but can't pay your bills.
4. Your banker makes a daily visit to see if you are still in business.
5. Your employees ask, *"How much is it worth to you?"* before performing any assignment.
6. Your suppliers have stopped returning your phone calls.
7. You have more returns than sales.
8. Your receptionist answers every phone call on the first ring and then hangs up.
9. It has been six months since anyone made a collection call to customers.
10. You are asked to justify your salary in front of a congressional committee (Or your name is Richard Fuld at Lehman Brothers).

Rather than focusing on overall revenue growth, you might want to consider the following measures:

1. **Revenue trends by customer**—Take individual customers over the course of a number of years and see what their trends look like. If you run a winery, you might ask, *"Have customers bought more or less wine in each succeeding year? Have they bought higher margin items or lower margin items? Have their tastes remained the same or shifted?"* Individual customer insights can help you target marketing efforts to your existing customers. These efforts are less expensive and typically have higher success rates.
2. **Revenue trends by category**—What products are most successful? Can you identify customer demographics that are tied to individual item sales?
3. **Customer mix**—Compare sales to existing customers with sales to new customers. What percentage of revenue comes from new customer sales each year? What does that trend look like over time? And how much of your revenue is coming from each of your different sales channels—for example, Wine Club members? How much is coming from allocations? You might need to focus on changing the mix to weather any short term fluctuations in sales.
4. **Revenue sources**—Where is the revenue coming from? Is it primarily distributors who are driving your sales, or is it online sales that are growing? What you learn from this analysis will help you target your marketing efforts so they are most cost effective.

"Before long it will be the animals who do the dieting so that the ultimate consumer does not have to."
Mimi Sheraton

"I highly recommend worrying. It is much more effective than dieting."
William Powell

Cash

You can do everything right when it comes to revenue and still go out of business without cash. Learn from the bankers—make sure you keep your eye on operating cash. This is what sustains your business over the long term.

Here's what to measure:

1. **Operating cash**—Operating cash flow is the net cash generated in the ordinary course of business. It is the total of cash received from customers, less cash paid to suppliers less any other expenses, including interest and taxes.

   Here's what to look for in your operating cash flow:
   - You want it to be positive
   - You want it to be greater than your net income
   - You want it to be more than your investment in equipment
   - You want it increasing over time

2. **Look at the number of days sales outstanding**—Days Sales Outstanding = Average Accounts Receivable Balance/Annual Credit Sales X 365 days. How many days of sales are tied up in your accounts receivable? If it is more than 45 days, you have work to do. Are your customers taking longer to pay? It might be time to consider incentives to get them to pay faster. You also might want to look at your order entry process to see if you can produce electronic invoices or e-mail payment reminders. You might also want to get customers setup on electronic funds transfer to speed up collection times.

3. **Relationship between receivables and sales**—Look at the percentage increase in revenue versus the percentage increase in accounts receivable. If accounts receivable is growing at a faster rate than sales, you will want to examine your credit policies.

Measurements

Days Sales Outstanding =
(Average Accounts Receivable Balance/Annual Credit Sales*) X 365* days

* *these numbers reflect an annual calculation. Substitute period to date sales and the matching number of days for other time periods.*

Inventory Turnover =
Cost of Sales/ Average Inventory

Days Payable Outstanding =
(Average Accounts Payable Balance/Annual Cost of Sales*) X 365*days.

* *these numbers reflect an annual calculation. Substitute period to date cost of sales and the matching number of days for other time periods.*

4. **Review your inventory turnover**—Inventory Turnover= Cost of Sales/Average Inventory. How much of your cash is tied up in inventory? For wineries, the answer is plenty. But how has inventory changed over the years? What does the trend tell you? And if inventory is growing at a faster rate than revenue, you need to look closely at your long term plans.

Other inputs

If increased revenue is your goal, you can't lose sight of marketing expenditures. Get a handle on the return on your investment from each of your marketing activities to see where you are getting the highest number of leads. Make sure that you are capturing expenses in sufficient detail to get good information for planning and budgeting purposes. Track costs for each marketing activity and then tie those costs to results.

Marketing measurements to consider:

- **Cost per sale**—Divide the amount spent for each campaign by the total numbers of sales that resulted from that campaign. Automated CRM (Customer Relationship Management) tools can be used to identify sales resulting from each campaign.
- **Cost per piece**—Divide the total cost of a marketing campaign by the number of pieces produced. Compare the cost per piece for your most successful campaigns and repeat only those that are most cost-effective.
- **Cost per qualified lead**—Divide the total cost of a marketing campaign by the number of leads that resulted.
- **Conversion rate**—Divide the number of sales per campaign by the number of leads. The resulting percentage will give you your conversion rate. If the number is low, you might want to review your lead qualification criteria as well as your sales processes.

"A balanced diet is a cookie in each hand."

Author unknown

"The alimentary canal is thirty-two feet long. You control only the first three inches of it. Control it well."

Kin Hubbard

"Statistics show that of those who contract the habit of eating, very few survive."

Wallace Irwin

Step 2: Look at what's going out.

There are diets that tell you to forget about intake, to just increase the calories you burn to reach your desired goal. Similarly, in business, there are companies that focus on reducing costs and driving additional efficiencies as a means of controlling their shrinking bottom lines. But these strategies, like fad diets, do not typically lead to long term success. Keep your eye on multiple factors and their relationship to the business inputs. A rolling budget in which you adjust expenses in proportion to actual revenues is one way to keep your winery on track. It is important to keep your eye on three main areas: cost of goods sold, operating expenses, and payables.

Cost of Goods Sold

You need to keep a close eye on the direct costs of items you sell. For a winery, that means considering farming costs in relation to cases produced for each harvest.

Compute the following …

- Cost per acre
- Cost per ton
- Cost per case
- Cost per bottle

… and compare your results to prior periods to determine your profitability potential.

When harvest yields are low, your farming costs per bottle are going to be higher than in higher yield years. These higher costs will not hit the financial statement for another two to four years. That means wineries have two to four years to plan for the release of a higher cost wine—ample time to plan new bottling strategies and to seek out preferred distributors and restaurants.

"I'm not overweight. I'm just nine inches too short."
Shelley Winters

"The cardiologist's diet: If it tastes good, spit it out."
Author Unknown

"A diet is a plan, generally hopeless, for reducing your weight, which tests your will power but does little for your waistline."
Herbert B. Prochnow

Operating Expenses

Compare individual expense categories to revenues for the current year to see how your trends are progressing.

1. Sales and marketing costs should be around 15% of your total revenues.
2. Examine your staffing needs by cost center and determine how many Full Time Equivalents are being employed in each area. Which cost center is generating the most revenues per employee? What can you learn from their results?
3. Which costs account for the greatest percentage of your total revenues? Have your staff come up with ways to reduce any major expense categories that are identified.

Payables

Consider how quickly you are paying your vendors and suppliers.

1. Look at the number of days payable—Days Payable Outstanding = (Average Accounts Payable Balance/ Annual Cost of Sales) X 365 days and compare it to the number of Days Sales Outstanding. If you are paying faster than you are receiving cash, you will be negatively impacting your operating cash flows.
2. Take a look at your vendor and supplier lists as well as your purchase history by vendor to see if there are options for changing payment terms without impacting your relationships.

"Never eat more than you can lift."
Miss Piggy

"A diet is the penalty we pay for exceeding the feed limit."
Author Unknown

"Where do you go to get anorexia?"
Shelley Winters

Step 3: See how you're doing.

Any diet and exercise professional will tell you that focusing on inputs or outputs alone will not help you sustain the effects of a diet. What you need is to focus on the relationship between the two. To put it simply, you can't eat more calories than you burn each day.

It's the same for businesses. You can't just focus on one side of the equation in order to sustain long term success. Companies who have maintained profits by cutting costs eventually can no longer grow. And companies that focus on constant year over year growth eventually run out of steam and begin to lose sight of their mission.

Net Profit

Net profit, reflected on the Income Statement, is the most common measure of operating success. But it is a short term result, and any profits made can be quickly withdrawn from the business. Likewise, profits reflected on the income statement could be tied up in long term assets on the balance sheet, thus reducing available working capital. It is wise to keep an eye on profitability without losing sight of your cash position and equity.

Operating Cash Flow

This measure is reflected on the Cash Flow Statement and does not include funds from investing, financing, or asset dispositions. Operating cash flow is a key indicator that a business will be able to repay any bank debts. Without a constant supply of cash, even the most profitable business can be at risk.

You can review each of the sources and uses of funds that contribute to your operating cash flow and determine if any adjustments are needed.

What it comes down to for businesses is a focus on three different aspects of business financial results—net income, operating cash, and return on assets. Because they are interrelated, these are sometimes called the triple bottom lines.

"My doctor told me to stop having intimate dinners for four. Unless there are three other people."

Orson Welles

Return on Assets

This ratio is computed by dividing net profit by average assets. It gives you a means of gauging the overall effectiveness of your business and shows you if your management strategies are effective. It can be used to compare results across industries and to determine the long term viability of your organization. An increasing trend in this measurement indicates that sales are rising faster than expenses and assets.

Summary

Healthy businesses focus on moderation. They look to keep the various aspects of their business in balance. They don't make drastic changes every year in response to changing economic conditions; rather, they keep their eye on their objectives, implement measurements that keep them on track, and accumulate reserves to sustain them. They look at income and expenses in relation to each other, and keep a watchful eye on operating cash. They pull measurements from the balance sheet to help them evaluate the effectiveness of business strategies. And they share information with key staff members on a regular basis.

These businesses also understand that strong financial results are just one aspect of success and monitor non-financial indicators (like employee turnover, brand awareness, and customer satisfaction) as well.

About BDCo

BDCo is an an accounting and advisory firm with deep knowledge about the wine and hospitality industries, and a passion for putting people first. Grounded in knowledge of financial measurements, the firm's services help companies achieve their goals and objectives by increasing the knowledge, awareness and understanding of everyone on their team.

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