Proven Processes Developed and Validated in 20+ Years of Real-World Experience Supporting Hundreds of Small Businesses. Sequel to best-seller version 1.0.

THE FINANCIAL OPERATING SYSTEM® Version 2.0

EMPOWERING BUSINESS OWNERS TO TAKE CONTROL OF THEIR FINANCES AND IMPROVE THEIR FINANCIAL FITNESS

BY CALVIN WILDER

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The Financial Operating System®

This book is dedicated to business owners

Too many business owners are struggling:

1. They are not making the money they hoped to be making when they started their business
2. They don't know why
3. They don't know what to do about it

Other business owners are doing OK now, yet want to know how to better use financial information to manage and scale their businesses for profitable growth.

I've helped many business owners overcome these challenges, empowering them to:

- ☑ Understand the financial performance of their businesses
- ☑ Take control of their finances
- ☑ Make more informed decisions
- ☑ Improve profitability

This book lays out a proven, 6-Step process for business owners to improve their financial fitness. This book also presents basic accounting principles and practices every small business owner needs to know.

This book is intended as a do-it-yourself guide. If you would like assistance implementing The Financial Operating System® including upgrading your bookkeeping, accounting and finance function, please contact me:

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Chapter 16

Step 5: MANAGE THE BUSINESS

After you know what you are trying to accomplish in Step #1, have defined the metrics with performance targets in Step #3, and have upgraded your accounting operations in Step #4--now the real work begins. You have to manage the business to hit your metrics and achieve your goals.

If needed, pull out your notes from Step #3 and re-familiarize yourself with your company's financial metrics and targets. These include:

- ☑ Metrics for what you want your business to look like 3 years from now.
- ☑ Metrics for the next year in order to be pacing to achieve your 3-year metrics.
- ☑ Metrics for the next quarter in order to be on track to achieve your annual metrics.
- ☑ Metrics for the next month in order to achieve your quarterly metrics.
- ☑ Weekly metrics to do the activities you need to do to achieve your monthly and quarterly metrics.

The process of setting weekly metrics imposes a basic operational plan of sorts as you define what you need to do on a weekly basis.

If you are new to this level of rigor in your goal-setting process, then I guarantee your metrics will evolve rapidly. You need a starting point. Don’t worry about perfection. Just getting some metrics in place that are actively monitored and discussed will increase focus and accountability in your people (and yourself!). In Step #6 you will improve the quality of your metrics as you learn from experience and iterate.

Chapter 17

Use a Metrics Framework

You need a framework to track all your metrics. Step #3 reviewed a few popular frameworks including EOS, OKR, and Gazelles. You could also adopt different components of each or build your own custom framework. Whichever framework you use, it needs to track metrics along different timeframes from weekly through annual metrics, as well as metrics for different departments, teams and individuals within the business.

Many companies are currently using a set of Google Sheets to track these metrics, while others are using software such as Paycor's 7geese product that are more specifically designed to tracking goals and metrics.

Even using an established framework, it is still a lot of work to set up company metrics. It will remain a work-in-progress for the life of your business. Setting up metrics is a process, not a destination. I'm still learning and iterating in my own businesses after 25 years of working with various metrics frameworks and occasionally building my own.

Metrics Review Cadence

Simply having metrics is not enough. You must ensure they are reviewed every week. By definition, weekly metrics are compiled and reviewed weekly.

Longer term metrics for quarterly and annual results can be forgotten if they are not reviewed regularly with an eye toward how you are pacing toward those metrics, though they could be reviewed every two weeks or every month to avoid spending too much time on longer term projections that don't change as frequently or can't be measured as frequently. You don't want to be thinking about and monitoring quarterly metrics only at the end of the quarter. You want to be forecasting quarterly results as you progress through the quarter. I have found it helpful to structure weekly metrics in a spreadsheet with 13 columns, one for each week of the quarter, plus two columns at the end to sum up actual quarterly results versus targets.

If achieving financial objectives is important for your business, then weekly metrics reviews need to be part of every management meeting at your company. If metrics are not reviewed, your people will conclude that metrics are not important. A regular cadence of reviewing metrics, identifying and addressing root causes when a metric is off track, and occasionally imposing accountability consequences when a metric remains off track keeps everyone focused on doing what they need to do to achieve your goals for the business.

Chapter 18

Annual Forecast

A key management skill is predicting and forecasting. You create a set of annual metrics at the beginning of the year along with associated operating plans and initiatives. As the year progresses, you may fall behind on some metrics and hopefully start pacing ahead on other metrics. Aside from simply knowing how you are pacing toward your annual metrics, you need to be able to manage decisions along the way.

This boils down to needing an annual forecast that is updated periodically. At a minimum, you need to be updating your annual forecast once per month.

A basic P&L forecast consists of 12 monthly columns plus 13th and 14th columns for full year numbers. At the beginning of the year, plug in your monthly budget figures into each of the 12 forecast columns, as your budget is the same as your forecast at the beginning of the year. Add a formula in the 13th column to sum the first 12 columns, thereby providing your full-year forecast. In the 14th column, enter your annual budget. This 14th column is static and provides a reference against which to compare your evolving forecast.

Optionally, you can add a 15th and 16th column to compare the forecast against the initial budget and report variances in dollars and percentage terms. You can also add columns to present prior year data and compare this year's forecast against last year's actuals.

A sample income statement forecast can be downloaded from TheFinancialOS.com.

Be sure to add calculated rows to your forecast spreadsheet to reflect your key P&L ratio metrics such as gross profit margin, LVM, and operating margin so that you are tracking and forecasting those metrics and focusing on them at least once per month.

After closing the books each month, replace the forecast numbers with actual numbers for the month. As you do this, the full year forecast in column 13 automatically updates. At the beginning of the year in Q1, your forecast is more of an educated guess of the next 9-12 months. As you advance through the year, your forecast converges on your actual results. By the time Q4 begins, 9 months of your forecast are actual results and the only variables are how you perform in the last 3 months of the year.

Understanding your forecast lets you make informed decisions when spending questions arise. If you are underperforming your sales metric, then you may need to curtail hiring or other spending plans in your service department, or reduce underperforming marketing and sales expenses, or both. If you are exceeding your sales metric,

then you may need to accelerate hiring or want to double down investment in successful marketing campaigns.

If your cash flow is seasonal or your business model requires significant investment in trade capital, or you have other factors that cause your cash flow to differ materially compared to your reported net profit, then you'll want to also model out a cash flow statement and a balance sheet for the next 12 months that links to your P&L forecast. You need to know what your cash flow looks like, especially if your business is not fully capitalized and able to comfortably absorb ebbs and flows in cash flow out of your cash reserve. Significant accounting skill is required to add those components, and you will most likely need to work with an outside resource unless you employ a skilled accountant who has done this kind of modeling before.

Chapter 19

Operationalizing Metrics

Metrics targets are usually set at a level that requires improving current results. Determining how to improve those results is where the real value is created. Here are some approaches that can help you to dig into operations and identify opportunities for improvement.

Segment Analysis

Many businesses have more than one kind of revenue stream. Evaluate each revenue stream and its corresponding cost to deliver. Identify your most profitable and least profitable revenue streams. Similarly, analyze your different types of customers. Identify your most and least profitable customer segments and your expected lifespan and lifetime revenue and gross profit per segment. Calculate your customer acquisition cost for each segment, and compare it to your lifetime gross profit. Consider ways to shift toward more profitable revenue streams and more profitable customers while reducing cost of customer acquisition as a percentage of lifetime gross profit.

Price Experimentation

Experiment with price increases to improve your knowledge of what customers are willing to pay for your services.

Customers derive value from the difference between the benefits received from you, and the direct and indirect costs to them of replicating your goods and services on their own, or of buying them from your competition. There is nothing wrong with increasing your prices, especially to those customer segments that get the most value from your services. The market will tell you when your prices are too high by stopping buying from you. Don't let your own preconceptions impose an artificial ceiling on your prices and your profits.

Increased pricing for a given transaction volume will increase revenue while costs mostly stay the same. Most or all of the price increase will drop to your bottom line as additional profit. Pricing is the simplest way to improve profitability, though it is not easy.

Pricing theory also suggests analyzing the impact of lowering prices. If lowering prices will dramatically increase sales volume, it may yield more net profit dollars at a lower percentage margin. This assumes you have the capacity to manage and deliver a much larger volume of services and deal with associated cash flow challenges. This is an impractical strategy for most professional services firms. You're not Walmart.

Analyze Cash Flow

- ☑ How does free cash flow on the cash flow statement compare to net profit on the income statement over the last year or two? Usually free cash flow is lower than reported profit if a business is growing and

financing increasing levels of accounts receivable. Other industries may be able to mitigate this challenge using extended supplier payment terms, but businesses have to make payroll every two weeks and usually don't have a lot of other accounts payable they can extend to offset rising accounts receivable.

- ☑ Identify the lines on the cash flow statement that are consuming cash and depressing cash flow.
- ☑ Consider your cash cycle. This refers to the timeline between 1) when you pay your direct labor and your vendors for customer work, and 2) when you receive payment from customers for that work.
- ☑ If cash flow is lower than net income, then consider ways to better align when you get paid by your customers and when you pay your vendors and employees. Consider how to invoice customers earlier and get paid faster and whether you can extend vendor payment terms.
- ☑ Sometimes accepting payment by credit card makes sense if payments are received faster with lower administrative collections costs and bad debt. Other times the processing cost to accept credit card payments is too expensive, costing more than its benefits.

Capital Allocation

Capital allocation is critical in a capital-intensive business, meaning a business that has a lot of property and equipment, a large accounts receivable or loan portfolio, or debt that was used to make investments or acquisitions.

For many service-based businesses, most of the time, it is less of a question of capital allocation and more a question of time allocation and management focus. Time is money and has an opportunity cost. Setting the right quarterly and annual goals is critical. A business coach once told me that his job ultimately is ensuring that his customers set the right quarterly goals.

Gap Analysis

Gap analysis is the comparison of the desired future state with the current state. The difference is the "gap." Looking at your 3 year goals, which ones will be hardest to achieve because they require the largest improvement to your current level of performance? Focus on closing the largest gaps between current performance and the level of performance required in your 3 year future state.

Zero-Based Budgeting

Budgets are often created by taking last year's actual results and making small changes to revenue and expense lines to create next year's budget. If there are major performance gaps to close, or ownership is looking to maximize shareholder value, then a different approach can be incredibly valuable.

Much as its name suggests, Zero-Based Budgeting starts from zero expenses, not from last year's expenses. While zero-based-budgeting theory can involve complicated math equations, its essential question is: If I started from scratch building the ideal business structure and team to achieve my

longer term objectives, what would I choose to spend money on, how much, and why? All expenses must be justified every budget period. There are no sacred cows. This approach forces consideration of return on investment, as the alternative is to put a dollar into the owner's pocket or into a higher-yielding investment instead of spending that dollar on the same thing as last year.

Aside from promoting financial discipline, this approach also stimulates strategic thinking about the overall business model. You must rebuild your business during the exercise. This strategic thinking is an under-appreciated benefit of zero-based-budgeting, especially for smaller businesses who are nimble enough to make major strategic changes in a short period of time.

Measure ROI

Small businesses tend not to operate on fixed budgets, but rather by determining what is worth spending money on as decisions arise. That's refreshing and more nimble than larger businesses. However, it is also dangerous if there is not an ROI framework in place to measure the return on investment from decisions to spend money.

For example, sponsoring a trade show might seem like a great way to meet new prospective customers. Yet how do you know if it actually was a good decision? There must be a system that tracks the number of new customers from the trade show, the volume of new sales and labor-loaded gross margin from those customers, and the expected lifetime value of profit generated from those customers compared to the cost of

sponsoring the trade show plus any other incremental costs after the show.

For large spending decisions, define the criteria used to evaluate successful investment and have a culture of measuring actual results and comparing against the criteria for success. Learn and improve your company's ability to invest in new initiatives and produce robust ROI.

Consider Outside Resources

Managing toward financial metrics might be new for you, especially if a major overhaul of your accounting policies and procedures is part of the change. There may be a learning curve, and Step #6 will help provide perspective on working through these kinds of issues. If you have a nose for finance, you may be able to manage these things yourself. If not, you will need to lean on another member of your management team or an outside CFO or financially savvy business consultant to implement the concepts in this book. Regardless, you need to ask the questions in this book of whomever is in the finance seat of the business and managing the accounting. As discussed in Step #3, the cost of outside experts may seem high. However, the ROI can be quite high and they more than pay for themselves when they help get the business on track to achieve its financial objectives.

Chapter 20

Delegation versus Abdication

The CEO of a small business, who is typically the owner or a principal owner, cannot delegate and abdicate financial management. Ownership has the most to lose if something goes wrong, as they have a huge part of their net worth invested in the business. Conversely, they have the most to gain from financial success.

While a strong, full-time CFO can drive financial performance, there are three issues for small businesses to consider.

1. Small businesses usually cannot afford a skilled, experienced CFO with a loaded cost of $250,000+ per year.
2. The CFO does not run sales and operations. Managers of those functions must follow through on what is required to drive financial performance. The CFO cannot do it alone.
3. The CFO cannot ultimately override an owner's decisions. The CFO can advise and cajole but is not the ultimate decision maker. If an owner's decisions are in conflict with driving strong financial performance, the CFO is hamstrung.

The small business Owner/CEO ultimately owns the financial performance of the business. If you can afford a good full-time CFO, then your life will be a lot easier. If, like most small businesses, you can't afford a good full-time CFO, then you need to actively oversee and guide the work of your Finance Stack. You in effect are the CFO, managing other resources as needed to get finance work done.

If you engage a fractional CFO, your life will be easier though you must understand the fractional CFO is not a full-time employee or legal officer of the business. She will be limited in what she can drive within the company. She can provide valuable insight and advice, and then it is up to you and your full-time management team to operationalize it.

In addition to these issues of management effectiveness, you as the owner need to consider embezzlement risk.

My firm SmartBooks was hired to provide bookkeeping and accounting and financial reporting services by a prominent local hospitality company which had been in business for over 100 years. SmartBooks replaced an accounting team of 2.5 people with a much more efficient, technology-driven solution which cost less than the loaded cost of one person. Given the fact the owner felt he needed to make a change, I knew there would be some issues to uncover once we took over the books. Sure enough, when we first reconciled a credit card account we found a discrepancy of over $100,000. Was this the result of embezzlement? I can't draw any definitive conclusions as there were no obvious smoking gun and the owner did not want to invest in a forensic analysis. It may

have just been the accumulation of sloppy bookkeeping over many years. We'll never know.

The reality is that a bookkeeper or accountant who is determined to steal money can bury the theft using a few basic methods that can be hard to discern, especially if the owner is not performing regular oversight. That's why if you search Google you will, sadly, find a large number of stories of bookkeepers stealing money from businesses and nonprofit organizations. What I can say about my customer, though, is that if the owner had reviewed the credit card statements and account reconciliation reports on a monthly basis, then the discrepancy would have promptly been discovered before it got anywhere close to $100,000. We could devote another chapter entirely to how owners can mitigate and detect fraud at their companies.

Decision Matrix

In order to successfully delegate management decisions while retaining control over high risk decisions and avoiding the abdication trap, business owners must have a clearly defined framework outlining which kinds of decisions require approval by which level of management and ownership. I call this framework the Decision Matrix. For example, the business owner may allow managers to grant up to a 5% annual raise to an employee, or issue up to a $500 credit to a customer, with larger raises and credits requiring ownership approval.

Chapter 21

HR Tools

This book is about finance, not human resources. However, when it comes to managing people to achieve financial results, then we are in the domain of HR. I'll present a few tools that many business owners find helpful.

Accountability Chart

Similar to a traditional org chart, the Accountability Chart from the EOS framework lays out a hierarchy of roles and employees in a company with each role and employee in a box. However, it is much more useful tool due to a few key differences:

1. There is a box for each key function needed by the business. Each box is labelled with the functional area of responsibility for the role, not the title of the role. This avoids distractions caused by titles. If the sales leader has a fancy VP title, and the operations leader has only a "manager" title, each is equally responsible for performing their function.
2. The name of each employee who is responsible for each role is listed in each box. The Accountability Chart is built based on what the business needs, not who it currently employs. If there is no employee in a

box, or one employee is in multiple boxes, the Accountability Chart calls that out.

3. Inside each box is a bulleted list of the primary responsibilities of the role. Even if job descriptions/missions or other more detailed documentation is not used, the Accountability Chart is a great, simple tool to keep straight who needs to do what within the business.

Job Mission

Traditionally companies have used a job description that lays out the knowledge, personal and professional skills, experience, educational prerequisites, and task abilities required of a position. The problem with this approach is that it focuses only on what the person has done in boilerplate terms in the past and what kind of tasks he will do at your company. It does not lay out what he actually needs to accomplish at your company, the attitude he needs to exhibit, and what exactly his performance will be measured against.

To me, the traditional job description is boring and nearly useless. It gets candidates to apply for the job, and then is often ignored because it doesn't tell you anything about what specific job outcomes must be produced and which attitudes need to be exhibited.

To illustrate my disdain for traditional job descriptions, note that almost every one I've seen contains a requirement to have "professional written and verbal communication skills." I ask: To what end? Does this mean customer service tickets will be resolved within 24 hours? Or that every project

will have a weekly customer status meeting laying out clear objectives and responsibilities for the following week?

Instead of bland boilerplate, I recommend businesses use a variation of the Job Mission concept presented by Geoff Smart in his book *Who*.

The Job Mission concept I recommend is a forward-looking document focused on the two most important things for a role:

1. The Job Outcomes that the role needs to produce. These are the outcomes that directly create value for the business. For example, a Customer Success Manager may need to retain 85% of customers every year as a Job Outcome. This is clearly and directly tied to business success, and this outcome would be balanced with a few other outcomes such as customer profitability and revenue growth. A traditional job description might mention calling on customers to conduct customer service activities and address areas of dissatisfaction. The problem with this traditional job description is that while yes, a CSM does need to talk with customers, that is a task to be done and does not indicate success or failure in the role nor reflect value created for the business.

2. What Attitudes the role needs to embrace to be effective in producing those Job Outcomes. A traditional job description might have sections for personal or professional prerequisites such as ability to maintain a professional demeanor or communicate effectively in oral and written communications.

> That's all well and good, but a Project Manager needs to be able to complete projects on time and on budget. A Project Manager may need to exude an attitude of urgency, ensure all project members attend weekly status meetings, and hold others accountable to complete their responsibilities. These attitudes drive success in the role. The "professional demeanor and effective communication" referenced in a traditional job description may sound good, but it is a vague platitude, not a visceral attitude that will resonate with target candidates and scare off those candidates who don't want that kind of job. Most traditional job descriptions are silent on attitudes required for success, which is unfortunate because attitude is usually more important than experience when it comes to doing a job well.

Weekly One-on-Ones

A manager owes it to her people to thoughtfully and diligently help them understand and improve their performance, which is a lot more than reviewing scorecard numbers or doing annual performance reviews. The more frequent the interaction is, the more effective it will be (to a point, obviously, of diminishing returns). If she breaks down performance reviews into shorter and shorter periods, she will usually realize that a weekly or biweekly meeting with each employee is a highly effective way to support her people, help them develop, and produce great results for her team and the company.

She will have authentic conversations aimed at understanding and driving performance. These

conversations will include some combination of goals for the prior week and next week; how the employee is feeling about their work; challenges, hurdles, roadblocks, and what the employee needs from his manager; positive and negative feedback; and open project issues.

This concept has been used in some businesses for decades, with the earliest written recommendation I’ve seen of the practice provided by Andy Grove in 1983 in his book *High Output Management*, written when he was CEO of Intel

About The Author

Calvin Wilder

Cal's passion is empowering small business owners to run healthy businesses and to become more financially fit. As a CFO, he partners with businesses to assess and manage the financial metrics which drive equity value for business owners. As an investor, he analyzes financial metrics to drive investment decisions.

Not a traditional CPA, Cal brings a refreshing mindset to small business accounting and finance. Having worked with hundreds of small businesses, Cal is an expert at operationalizing financial management, with a knack for effectively balancing accounting needs, reporting priorities, operational requirements, and budget constraints.

An entrepreneur himself, Cal has founded or co-founded 8 companies so far in his career including one that was acquired by Staples in 2006. Recruited to serve on various corporate Boards, he has advised Intacct (acquired by Sage for $850M), MineralTree (raised >$70M in VC funding and acquired by Global Payments for $500M), and G2 Technology Group (bootstrapped, acquired by private equity firm Great Hill Partners and subsequently CDW).

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