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

#1 AMAZON BESTSELLER

THE FINANCIAL OPERATING SYSTEM® FOR MARKETING AGENCIES

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

BY CALVIN WILDER

ISBN: #

The Financial Operating System®

This book is dedicated to owners of marketing agencies

Too many agency 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

Others 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 agency 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 2

Step 2: ASSESS CURRENT FINANCES (YOUR WHAT)

This assessment defines WHAT you have now in your business, in terms of financial condition and financial performance.

Financial Condition

By financial condition, I mean what your agency's balance sheet looks like right now. The balance sheet presents your assets, liabilities, and owner equity. It reflects the accumulated profit and loss of the business over the years as well, how much of that profit you have distributed out, and how you have chosen to finance the business through some combination of equity, debt, and retained profit. The balance sheet doesn't tell you how profitable you are now. Rather, it helps inform you about the strength or weakness of your financial foundation and how much capacity you have for error, losses and investment that you have to work with as you implement changes within your agency.

Specific questions when assessing financial condition include:

- ☑ Does the agency have a healthy cash reserve in the bank? Or is it cash-poor and struggling to consistently make payroll?
- ☑ Does it have debt, maybe borrowing on a bank line of credit or carrying credit card debt or equipment leases or a term loan?
- ☑ Has ownership built up a cushion of equity in the business, or has most profit been distributed out of the business?
- ☑ What is the Days Sales Outstanding, reflecting cash tied up in accounts receivable? What is Trade Capital, which largely reflects the difference between accounts receivable and accounts payable?
- ☑ If the agency collects large upfront deposits or retainers, how much of the agency's cash balance is earmarked for future services that it must deliver to clients?
- ☑ Does the agency maintain a separate bank account to house client funds used to pay for third party media or is it co-mingling client funds in the agency's operating checking account?
- ☑ Is there access to capital, meaning for example an untapped bank line of credit or owners who will contribute cash back into the business if needed or if a growth opportunity arises? Or must the business be self-financing without access to external capital?

Financial Performance

By financial performance, I mean a set of metrics typically geared around profitability and revenue growth over a period of time. These metrics come from the income statement, also referred to as the profit-and-loss. Although there is a correlation between strong balance sheets and healthy profitability, it is possible for the business to be generating high current profits while maintaining a weak balance sheet, or conversely to have a strong balance sheet from retaining prior years' profits while current profitability is weak.

Specific questions when assessing financial performance include:

- ☑ Is revenue growing or shrinking, and at what rate?
- ☑ What is the resale margin on third party media? Is there credit risk on media resale or do clients prepay?
- ☑ What are gross and operating profit margins and how are those margins trending?
- ☑ What is the Labor Value Multiple?
- ☑ Do we have data to report on client and project profitability to know which clients or kinds of projects are most profitable or detracting from profitability?
- ☑ What percent of revenue and gross profit is being invested in marketing and sales? What is the cost of client acquisition versus lifetime client value?
- ☑ What percent of revenue and gross margin is spent on general and administrative overhead?

☑ How does free cash flow compare to reported net profit?

If some of these metrics sound foreign to you, don't worry, we'll dig into them later in this chapter as well as in Step #3 when you define your specific metrics and goals.

Look at trends in these metrics over the last 3-5 years, as well as the last 3 months of this year compared to the same 3 months last year. Consider the longer term picture as well as the most recent data. I hope (though usually don't find) that the business has a forecast through the end of the current year, and factor that data into the assessment.

Initial Observations

A solid foundation of good, consistent bookkeeping and accounting practices is required in order to produce meaningful financial reporting. Maybe you will find that your accounting needs a little bit of upgrading in order to give you this information (the best case). Or perhaps your books are a mess and you don't have the data to calculate these metrics, or you can't trust the data even if you can calculate some of these metrics (unfortunately the all-too-common case). If you have this problem, you'll find the chapters around Step #4 to be helpful in upgrading your accounting to be able to get better reporting.

Although we don't yet know what your specific metrics and targets should be, we can make some observations relative to your business objectives after this initial review.

- If your goal is to grow, we can see how fast revenue has grown over the past year.
- If your goal is to have fat profit margins, we can see what your gross and net profit margins are.
- If your net profit margin is low, we can see which segment(s) in the business are dragging down overall profitability.
- If you want to pay off debt, we can see how much profit and cash flow you are generating that is available to pay down debt and over what period of time debt can be repaid.
- If you want to fund your retirement account and be able to retire in a certain number of years, we can see how much you are getting paid in bonuses or profit distributions (net of taxes) that you could save and invest in excess of the salary or draw that you use to pay living expenses.

Again, we don’t know what your specific metrics should be as we have not gone through all steps of The Financial Operating System®. However, we can assess whether current performance is directionally accurate and consistent with your stated goals. Or whether you have a problem to overcome, if for example, your stated goals conflict with recent performance.

The initial assessment in this Step #2 usually yields an overall conclusion that falls into one of the following buckets:

1. Good: Your balance sheet has no debt and a significant cash reserve. Net profit margin is near 10% or better, and you have modest revenue growth most years.

Overall your finances are in good shape, and you want to focus on improving a few areas starting from a solid foundation.

2. Mediocre: You have limited capitalization with some debt and/or a low cash reserve. Net profit margin is positive but less than 5%. Either there is no sustained revenue growth, or there has been no improvement in profit margin despite revenue growth. Things are not dire and you have time to work through your issues. You may have some major work to do in order to get the business performing as you want, or perhaps there are just a couple of metrics that could drive major profit improvement if managed a little more closely.
3. Bad: Your net profit margin is negative, and you have been spending down your cash balance and/or borrowing money to fund operating losses. Perhaps you sometimes skip owner payroll to help make ends meet. You have a short window of time to decide and implement major changes in your agency to make it financially viable with at least slightly positive cash flow in order to buy you time to make further improvements to get the business healthy longer term.
4. Don't Know: Your books are in such bad shape that you cannot perform an accurate assessment. Bank and credit card accounts in QuickBooks have not been kept updated and reconciled each month, and you have some other accounts on the balance sheet that you can't explain. Your chart of accounts is disorganized. When you run financial reports, you don't trust they are accurate. At least you have some cash in the bank and don't have trouble making payroll so things must

not be too bad. You can continue to operate the agency while you get control over its finances.

You may need outside expertise to make these assessments depending on your finance skill as well as the skill of whoever is doing your accounting and financial reporting. If you are in the Don't Know bucket, you definitely need outside expertise to complete this assessment.

My company SmartBooks (smartbooks.com) does this assessment as part of our Financial Acceleration Program and for many clients we onboard into monthly bookkeeping and accounting services. I can count on my hands the number of clients we have walked into who have had clean books and a good set of performance metrics in place (excluding venture-financed companies with the luxury of being able to afford to employ a good CFO). Usually when we engage with a new client, we clean up their books and accounting practices and put in place their first real financial reporting package. If you have problems with your books and reporting, that's normal for many small businesses, and The Financial Operating System® is for you!

Step #4 goes into detail about important issues that go into upgrading and maintaining a proper accounting function. Here are a few basic issues that you may encounter when doing this assessment:

- Bank and credit card accounts have not been formally reconciled in QuickBooks or there are old uncleared items that are not resolved during reconciliation

- Third party media deposits from clients are not accurately reported on the balance sheet
- The chart of accounts is not segmented between cost of goods sold, direct labor costs, marketing and sales costs, and general and administrative costs
- Payroll expense is not posted with an accurate split between wages, payroll taxes, and employee benefits
- Accounts receivable contains old, uncollectible balances that need to be written off
- Accounts payable contains old balances that are not going to be paid and need to be written off
- Revenue and associated cost of goods sold are not reported in the same month, thereby making monthly financial statements inaccurate

You may be able to resolve these basic issues internally. If not, you'll need to bring in outside expertise to perform this work and manage these issues. These are fundamental bookkeeping and accounting issues that are non-negotiable if you want to be able to use accurate financial reporting to manage your business. There are more advanced concepts to consider, but first fix the basics.

You'll find that you need to do some calculations and analysis outside of QuickBooks. While QuickBooks is the dominant small business bookkeeping software in the U.S., it does not actually automate accrual accounting nor provide much useful financial reporting beyond basic financial statements. You'll need someone who knows debits and credits accounting to ensure the monthly financial statements are accurate. You'll also need someone with a financial mind to get you the right analysis and metrics to be able to distill the raw data in QuickBooks reports into actionable insights you can use to make business decisions.

As you look at your financial statements, you may wonder about the option that QuickBooks presents to run reports on either the cash basis or the accrual basis. Unfortunately, QuickBooks reports are often not accurate on either basis. Depending upon how transactions are entered, QuickBooks may present assets and liabilities on a cash basis balance sheet that would not exist on a pure cash basis financial statement, and certain non-cash transactions may still be included on the income statement. As far as accrual accounting is concerned, QuickBooks does not magically apply revenue recognition and expense recognition rules to transactions. The accrual basis reports provided by QuickBooks report revenue based on customer invoice dates and expenses based on vendor bill dates or payment dates if there is no associated bill. Accrual basis reports will only be as accurate as the adjusting journal entries that you post to recognize the right amount of revenue and expense each month. For purposes of this basic assessment in Step #2, use accrual basis QuickBooks reports as this hybrid approach is more accurate than cash-only accounting.

Conclusion

After you have determined your current financial condition and assessed your financial performance, take note of areas in which your current condition and performance align with your long term goals. Also take note of areas where you have gaps or that are in conflict with your long term goals.

Write down these notes, as they will be important for Step #3 of The Financial Operating System® when we define your financial metrics and targets.

Chapter 3

Income Statement Glossary & Example

You may be wondering what some of the terms mean that were referenced in the last chapter. Below is a glossary of basic income statement terms that are a starting point in assessing financial performance.

Accrual Accounting = The practice of recognizing revenue and expense in the time period in which goods and services are provided, received, or consumed. This is different from when invoices are dated or when they are paid. This is typically a critical practice to adopt when upgrading financial management of a small business. Chapter 25 goes into further detail on Cash versus Accrual Accounting, and Chapter 26 provides a practical solution for small businesses.

Revenue = Sales to clients (subject to any accrual revenue recognition standards).

Gross Revenue = All the goods and services invoiced to the agency's clients regardless of who fulfills them. In the context of an agency that resells third party media, Gross Revenue includes the full price of that media even if media cost is netted out of reported revenue as contra-revenue.

Contra-Revenue = Negative revenue resulting from items fulfilled by third parties that your agency resells and that you net out of agency revenue, recognizing only the markup or resale margin as net revenue to your agency. This is mostly third-party media that you buy on behalf of clients. Historically it might have been a billboard or radio ad; these days it also includes Google adwords or Facebook ads. With these kinds of sales your agency operates as an agent or broker, recognizing only the net revenue on its income statement. Unless third party media is a component of a broader offering your agency sells (not a standalone item delivered only by a third party) or your agency takes inventory or profit risk on media purchases, third party media is usually considered contra-revenue.

Net Revenue = Gross sales revenue minus any contra-revenue from reselling third party media or other goods and services delivered by third parties. It is Net Revenue that you have available to pay your agency's operating expenses. Net Revenue may simply be called "Revenue" unless the discussion is focused around gross revenue, contra-revenue and markups where net revenue is a clarifying term.

Net Revenue Margin = Net Revenue dollars divided by Gross Revenue dollars, expressed as a percentage. This reflects the markup and margin achieved by the agency when reselling third party media, sometimes with GL account filters required to isolate such markup and margin.

Cost of Goods Sold (COGS) = Products and services that your agency uses as part of fulfilling and delivering services to clients. COGS may include software tools for SEO analysis, images or modeling for creative projects, or website hosting services if you host websites for clients. Third party media is usually considered contra-revenue unless it is a component of a broader offering of your agency and your agency takes inventory and profit risk on media purchases. Similar to contra-revenue, COGS reflect costs paid to third parties that are not available to pay your agency's operating expenses. COGS does not include your labor costs, which are accounted for in Direct Labor Costs.

<u>Pre-Labor Gross Profit</u> = Revenue minus COGS. For some agencies where the only thing they sell is professional services, there may be little or no COGS and thus little or no difference between Revenue and Pre-Labor Gross Profit. Other agencies that focus more on reselling marketing technology or on bundling technology and services in their offerings have larger COGS and greater need to monitor and manage Pre-Labor Gross Profit.

<u>Direct Labor Costs</u> = Expenses associated with the people who directly provide services to clients including salaries, benefits, payroll tax, training, and other associated costs. For larger agencies this includes any client service managers who may be semi-billable or even non-billable. Direct Labor does not include marketing and sales staff who bring in new business or general and administrative staff who support the overall function of the agency.

<u>Labor-Loaded Gross Profit</u> = Gross Profit minus Direct Labor Costs. This is a measure of how much value you are creating

as it represents the difference between the price clients are willing to pay for your services and your cost to provide those services.

Gross Margin = Gross Profit dollars divided by Revenue dollars, expressed as a percentage. Gross Margin may be Pre-Labor or Labor-Loaded.

Operating Profit = Labor-Loaded Gross Profit minus the cost of marketing and sales and minus the cost of general and administrative overhead. This includes depreciation as depreciation reflects the cost of assets used in the business. It does not include interest and income tax.

Operating Margin = Operating Profit divided by Revenue, expressed as a percentage. It reflects the overall profit efficiency of the business factoring in both Gross Margin (how efficient and valued your service operations are), how efficient and productive your marketing and sales operations are, and how efficient your general and administrative overhead are.

Net Profit = Operating Profit plus or minus any non-operating items such as interest income, interest expense, and any one-time gains or losses from something like a sale of an asset or a fire or theft. Interest income and expense are not operating expenses as they reflect a financing decision rather than operating revenue or expense of the business. One-time gains or losses are important to identify and separate from the core performance of the business. Net

Profit is, however, the bottom line performance of the business.

Net Margin = Net Profit divided by Revenue, expressed as a percent.

Cash Flow = The actual cold, hard cash produced or consumed by the business in a period of time. Cash Flow is always different than the Net Profit reported on the income statement. There are nuanced definitions of cash flow, including or excluding purchases of fixed assets, debt repayment, profit distributions or dividends, etc. EBITDA is a common measure of cash flow. For my purposes, I look at the operating cash flow of the business prior to financing decisions such as debt borrowing or repayment or dividends to owners. I want to know how much cash the business is generating (or consuming), and thus how much is available to the business owner to allocate based on the owner's goals.

Here's an example of an Income Statement with various margin percentage metrics added.

Gross Revenue	$500
Cost of Media (contra-revenue)	$400
Net Revenue	$100
Net Revenue Margin	20%
Revenue (net revenue)	$100
Cost of Goods Sold	$10
Pre-Labor Gross Profit	$90
Pre-Labor Gross Margin	90%
Direct Labor Cost	$50
Labor-Loaded Gross Profit	$40
Labor-Loaded Gross Margin	40%
Marketing & Sales Expense	$13
% of revenue	13%
General & Administrative Expense	$17
% of revenue	17%
Operating Profit	$10
Operating Margin	10%
Other Income / (Expense)	-$1
Net Profit	$9
Net Margin	9%

Table 3.1

This is the kind of report you should be getting from your bookkeeper or accountant as part of your monthly reporting package. Note this format includes different segments of expense and profit, as well as margins associated with those segments. This is far more insightful than the traditional income statement (profit and loss report) produced by most accounting software. You want your bookkeepers and accountants thinking about business performance and helping you understand it with reports like these, not just reporting historical financial statements in whatever format QuickBooks defaults to.

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).

Cal can be reached at Cal@TheFinancialOS.com. His accounting business can be reached at www.smartbooks.com. He looks forward to hearing from you.

THE FINANCIAL OPERATING SYSTEM®

01 Identify Your WHY

02 Assess Current Finances

03 Define Metrics and Targets

04 Upgrade Accounting Operations

05 Manage the Business

06 Learn, Iterate and Improve

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