



Hello! My name is Wayne McMahon. I have been involved in financial and operational consulting with retailers for over 30 years. Recently, we explored the most common mistakes made by furniture retailers and now we will review the five most important things to learn, which will enable the retailer to avoid those mistakes. Those fundamental aspects of managing a retail business include:

- Developing and monitoring a financial and business plan
- Learning and using the key financial metrics
- Understanding and employing the most important Inventory Metrics
- The implementation and operation of efficient Systems to enable the achievement of the desired outcomes
- Providing management with the concise and precise reports that will provide the data to promote the making of critical and effective decisions

We will first discuss the Development of a Financial and Business Plan and its' importance to your business.

A financial and business plan provides a roadmap for the achievement of higher profitability and increased cash flow. The importance of a detailed, thoughtful plan cannot be overemphasized.

The future of your business and personal status can be dependant on a sound financial plan, including management of your business and finances, promotion and marketing of your business, achievement of your goals and objectives, outside sources of capital and obtaining credit from suppliers.

It is not an overstatement that a sound financial and business plan is a necessity for anyone who wishes to start, operate or grow a business. Without this level of planning, there typically is trouble.

Many entrepreneurs procrastinate when it comes to the preparation of their financial plan, despite its critical importance. They might believe that they do not have the skills to prepare the plan, perhaps there are time constraints or they might feel that things change too quickly to prepare an adequate plan. However, just as no reputable builder will begin construction or commence renovations, without a blueprint, neither should business people operate in the dark, by conducting nor starting a business, without a solid financial plan.

Business planning is key to any business throughout its existence. Every successful business regularly reviews and updates its financial and business plan. This review should be part of a three-stage process, coming after a comprehensive review of current performance and the identification of the most likely strategies for growth and enhanced profitability.

Upon the completion of your progress review and identification of your targeted growth areas, you should re-visit your business plan and develop it into a road map into the future of your business. A good plan should set the course of a business over its lifespan, by providing a means of ensuring that the key objectives are met. Increase your chances for success by adopting a continuous and regular business-planning cycle that keeps the plan up-to-date.

When you review your financial and business plan you need to take stock of where the business currently is, where you want it to go and then use the plan to set a course to achieve the objectives that you have established. By regularly comparing the actual business performance against the plans and objectives that you have set, you have the greatest possibility of meeting your goals. You must have a clear picture of the current status of the business and why you may have over or under performed. The successful business will assess its progress, on an ongoing basis, typically every quarter or six months.

The basic components of a financial and business plan include current and Proforma balance sheets, income statements and a cash flow analysis.

When preparing your financial plan, net profits are obviously a vital indicator of the performance of a business. However, the generation of a profit does not guarantee its continued development or even its survival. More businesses fail for the lack of cash rather than for the lack of profits.

Sales, expenses and profits do not necessarily coincide with their related cash outflows and inflows. Even though a sale may have been completed and the merchandise delivered, the receipt of the payment may have been delayed, as a result of credit terms, provided to the customer. Other key areas of cash impact include the purchase of inventory or equipment and the repayment of supplier or other debt obligations. Cash receipts often may fall behind cash disbursements, meaning that a business could experience a cash shortfall, while reporting profits. It is essential to forecast cash flow, as well as projecting sales and net profits.

When preparing your financial plan, you should take realistic views about your prospects and objectives. Sales forecasts should be reasonable and attainable. Costs should not be underestimated. Assumptions on the availability of credit or equity should be conservative and realistic. Be careful that you don't become mired in the minute detail of the business operation, while failing to recognize the key strategic factors.

Once you have prepared your financial and business plan, it needs to be implemented and then continually monitored to make certain that the objectives are being achieved. The plan needs to be part of an ongoing, rolling process, with regular assessment of your performance against the plan and development and agreement upon a revised forecast, if necessary.



A major aspect of the monitoring of your financial and business plan is the Understanding of the Financial Metrics of your retail furniture operation-

All furniture retailers should be receiving timely, accurate financial statements either from their in-house business management or accounting system or from their external or internal accountants. These financial statements should be providing the dollars of such P&L components, as sales, expenses and net profit, as well as such numbers as receivables, inventory and payables. Without question, these accounting statements are vital for the reporting and tracking of overall business performance. However, much more useful information can be provided for management purposes, if the financial data is in the form of ratios or percentages, in addition to absolute dollar values.

The key financial ratios and percentages can be easily compared to specific retail furniture industry statistics, to determine how your company compares to other similar retail furniture operations. For example, a great analysis of certain aspects of your business is obtained through the determination of a ratio such as the value of sales produced per payroll dollar. The percentage, of total payroll expenses of sales, provides a tremendous insight into the efficiency in which your company utilizes its payroll dollars for a particular timeframe or in comparison to other furniture retailers.

The use of the key financial metrics, as a supplement to the absolute numbers, contained in your financial statements will provide you with the knowledge of both the financial performance and the financial position of your company. The ability to use this information to improve the efficiency and profitability of your business will result from the understanding of these financial metrics.

What are the most important Financial Metrics?

The most important of the key financial metrics and the most frequently referenced is net profit, as a percentage of sales. Since net income and income tax, in a small business, are often influenced by factors outside of the normal course of operating a business, it is suggested that net profit before income taxes be used as this key measurement. For example, if abnormal management remuneration has been taken, due to tax planning considerations, it is further suggested that the net profit before income taxes, be normalized in order to provide a truly meaningful and comparative financial ratio. Historically the typical retail furniture store has generated net profits before income taxes, in the range of 3 to 4 percent of sales. However, the top profit performing operations achieve double-digit net profits before income taxes. How can we identify the reasons for this profit gap between the typical and the high profit store?



Net profit is contingent upon the effectiveness of merchandise buying, pricing policies and procedures and the control of both fixed and variable expenses.

The typical furniture retailer will achieve a gross margin of 43 to 44%. The attainment of a higher gross margin can mean that net profits will increase, in corresponding fashion, but only if adequate expense controls exist. Conversely, a lower gross margin, than 43 to 44%, may often mean that net profits will be lower than the typical 4% of sales. However, not always does this relationship apply. Some furniture retailers have developed a business model whereby low selling prices and low gross margins are more than offset by the effects of excruciating expense controls, so that high net profits are still obtained.

The typical retail furniture store spends 39 to 40 percent of sales or 90% of its gross margin dollars on operating expenses, leaving only 4% of sales or 10% of gross margin dollars as the net profit before taxes.

What are the key financial ratios, which make up most of the operating expenses?

Payroll expenses, including wages, salaries, bonuses, taxes, group insurance and benefit plans, typically consume half of the total operating expenses, at 19 to 20% of sales.

Building-related or occupancy costs will usually be in the 7.5% of sales range, but in major metropolitan areas may be even greater as a percentage of sales.

Advertising expenses should be held to the average of 5 to 5 ½ percent of sales, a ratio that is attained by the typical furniture retailer.

The three major expense categories of payroll, occupancy and advertising usually account for about a third of sales dollars or 75% of gross margin dollars.

To obtain better than average net profits, to achieve double-digit net profits, these 3 expense categories must be kept under control, at ratios better than the average. Sometimes the results are achieved by exceptional sales per square foot or outstanding gross margins. However, the key to your successful business model must be the understanding of the importance to net profits of not only suitable sales levels, but the dollars remaining from gross margin dollars after providing for the 3 primary expense classifications.

If you plan and monitor these important financial ratios to ensure that they do not exceed or are less than the average furniture retailer, you too can achieve double-digit net profits.



Just as important as the understanding of the key Financial Metrics is the understanding of the most important Inventory Metrics of a retail furniture store-

We have previously discussed the importance of these key financial metrics and ratios, such as net profit before income taxes, gross margin and the major expense components, of a retail furniture store. In addition to these critical profit and operational measurements, furniture retail store management must have a thorough understanding of the relationship of the most significant business asset, "Inventory", towards profitability.

Typically, there is no other controllable facet of the business, which can impact profits, to the same degree as inventory. A well managed merchandise inventory requires not merely product knowledge, but an in-depth understanding of the key inventory metrics, which can be used to assist the making of those all important decisions, which ultimately result in either high profits or mediocre results.

Just as the key financial ratios and percentages can be easily compared to specific retail furniture industry statistics, so also can the fundamental inventory metrics be employed, to determine how your company compares to other similar retail furniture operations? The ability to use this information to improve the efficiency and profitability of your business will result from the understanding of these inventory metrics.

Some of the most important Inventory Metrics are:

- Inventory to sales ratio
- Gross margin return on inventory (commonly called GMROI)
- Inventory turns
- Inventory aging percentages
- Best sellers in stock days

The inventory to annual sales ratio of high profit stores is normally in the 15% range, while the average furniture store will have a 20% ratio. A direct relationship exists between inventory levels and profitability. Those stores, which exceed the 15 to 20% ratio of inventory to sales, will almost always have significantly less profits than those operations, with excellent inventory management. The importance of maintaining a proper inventory level cannot be overstated. Typically a furniture store has about 50% of its asset value, tied up in the form of inventory. This dollar value does not appreciate or age like fine wine – it comes with significant costs.



Overstock is by far the most costly problem facing furniture retailers everywhere, because of the three types of costs that are associated with inventory overstock:

1. Carrying costs, the annual out of pocket expenses of carrying inventory, amount to 20 to 30% of the inventory's original landed cost – and this may be the smallest of the three.
2. Excess inventory leads to high markdowns. If there is a lack of a systematic clearance of slow moving items, a loss in gross margin of up to 33% may be incurred.
3. Stock-outs, whereby sales and gross margin are missed due to out of stock best sellers, can cost even more in lost profits than carrying costs and excessive markdowns combined.

Keep your Inventory to Sales ratio under 20% and preferably close to 15%!

Now let's look at gross margin return on inventory:

GMROI is perhaps the most widely used inventory efficiency tool in the retail furniture industry. It takes into account both gross margin and turns. That is to say that there are 2 sides to the coin that must be examined. Gross margin tells you how much money you are making from the sales of your inventory while turns tell you how often you sell it. The key lies in the relationship of the mix of the two. GMROI is typically expressed as a \$ amount and can be thought of as how many dollars you make per dollar of inventory currently invested. The GMROI of your entire business, your categories, your vendors, and your specific items are all-important in implementing strategies to maximize your return on investment. A simple formula for the calculation of GMROI is:

ANNUALIZED GROSS MARGIN \$ DIVIDED BY AVERAGE INVENTORY DOLLARS

While GMROI does vary by product category, the typical store achieves a GMROI of \$2.30, while a high profit store will probably be in the \$3.00 plus range.

You should target your GMROI for the \$3.00 range to achieve strong net profits!

One of the key factors of GMROI is the inventory turn rate, which is achieved.

Inventory turns are the number of times that sell the value of your inventory on an annual basis. Turns are calculated by taking your annualized cost of goods sold and dividing it by your inventory. As your turns increase, the average cost of your inventory, at least proportionate to sales, decreases. The result is a decrease in the carrying costs of your inventory, which we have already seen can be 30% or more per year. The positive impact on net profits, of achieving

greater inventory turns, is enormous. Studies have shown that an increase of one turn per year can be the equivalent of an additional 7 to 8% of gross margin. That's huge!

The targeted annual inventory turns of a retail furniture store should approach the 3 to 3.5 range. The successful result will be strong profitability.

To obtain high profits, a low inventory to sales ratio, a high GMROI and high inventory turns; a retail store cannot afford the luxury of sitting on inventory, which is not moving. The costs are so significant of carrying "dogs" that profits are reduced tremendously, cash flow can be tightened to the danger point and the life of the business can be put into jeopardy. How can the aging of current and dormant inventory be measured? By determining the elapsed time and the sales activity (or inactivity) of an inventory item from the received date to the current date, the inactive products or "dogs" can be determined. If an item has not had sales activity, within 60 days of its receipt, it likely will be a dog, not a best seller. Sometimes, better merchandising or the determination of a more appropriate selling price can reverse the trend, but most often the non-moving item needs to be cleared, in the shortest possible timeframe, but at the greatest possible selling price. Get emotions and personal preferences out of the equation and move those "dogs". What then is a reasonable ratio of current inventory to "dogs"?

Strive to achieve at least a ratio of 75% of current inventory to 25% of dogs, or slow moving items in order to obtain the desired GMROI and inventory turns.

How can sales and gross margin dollars be improved, to result in the higher profits, which are measured by these important Inventory-related performance indicators?

Most gross margin dollars (in fact, 80%) are generated by 20% of your inventory items. If you allow your best sellers to get frequently out of stock, you are losing significant sales and gross margin dollars. You can't sell what you don't show! The high profit stores keep their best sellers in stock 95% of the time.

To maximize your sales and gross margin dollars, ensure that your best sellers are in stock at least 90% of the time.

If you plan and monitor these important inventory ratios to ensure that they are better than those attained by the average furniture retailer and are approaching those of the high profit stores, you too will be taking the steps, which can result in double-digit net profits.

Of course, no business can achieve the desired Outcomes without strong Systems and Procedures.

In this 5-part series on the most important things for a furniture retailer to learn, we have seen the importance of developing and maintaining a sound financial and business plan. The understanding and the tracking of the key financial and inventory metrics have been shown to be

critical factors in getting hold of your business, so that you can achieve the targets defined in your plan. However, the existence of a financial plan and the understanding of the basic ratios and measurements cannot by themselves guarantee the desired outcome.

You don't just drift to greatness...you achieve your goals by planning, determination and follow through. "Seat of your pants" retailing is dead in today's market economy. To reach your full potential and get the most out of your business in terms of profit and enjoyment, you must implement effective systems and have a strategy to follow up and monitor those systems.

Your company is similar to a football team. Even if you have the best quarterback in the NFL a win at the Super Bowl is far from guaranteed as there are many facets that have to come together seamlessly. The offense, the defense, special teams and all the specific positions need to work together and be properly guided by their coaching staff in order for the "Team" to succeed. Similarly, your business requires proper leadership to enable all of your departments (sales, finance & administration, warehousing & delivery, and customer service) to come together so that your team will accomplish the collective objectives of the business.

In order that the desired targets of a business are attained, the general manager or coach must coordinate the efforts of the team members, so that all of their activities and work are performed, in a complimentary manner. This means that effective and smooth-running systems, for all aspects of the business, must be designed and implemented. Everyone in the organization must understand the systems and receive on-going training in their operation. It is of paramount importance that each employee understands and follows the systems – they are not optional but are the guideline for conducting their jobs and operating the business efficiently. The business leaders must set an example, to the employees, by diligently following the systems and ensuring that all team members to do likewise.

The creation and implementation of any system is not the end, but the beginning of the process of achieving the desired outcomes.

Problems can and do occur in all business activities. Systems must be in place to identify the problems. The exact nature of the problem and the root cause of the problem need to be identified. Problems must be prioritized so that the energies of the business and the employees, remains focused on the key tasks and objectives.

Each system must have a constant means of measuring its effectiveness, to ensure that the various components and sub-systems are working together to achieve the common goal. Every system must be continually monitored to ensure that undesirable changes do not occur and to eliminate any rough spots, which might develop. Inspect what you expect! The continual review of the various systems and procedures not only helps to identify problems or potential problems, but also provides a forum for solutions and improvements to the respective process.

The business, which stands pat and does not constantly seek improvements, is actually going backwards. You cannot simply maintain the status quo. The quest for on-going improvements to systems and procedures must be never-ending. Management must embrace and foster the attitude of constantly seeking better ways of doing things, in order to truly grow the business.

The management of a retail furniture store must be provided with the critical data in a concise yet precise reporting method -

The effective manager should not be mired in detail, in order to monitor the progress towards achieving the desired outcome, as defined in the financial and business plan. The financial and inventory metrics need to be provided in a readily available and easy to understand format.

The primary management reports must be accurate and prepared on a timely basis. Anything less than first-class management reporting standards is simply unacceptable.

The key financial statements, consisting of the balance sheet, income statement and statement of cash flow must be available, on a demand basis, for interim reporting, and within a few days of the end of a period, on a fully reconciled basis. There is simply no valid excuse for settling for lesser reporting standards.

To augment the financial statements, a number of valuable financial reports, need also to be provided to management. These management reports include:

- Comparative financial statements to the financial forecast or budget
- Analysis of the major deviations or variances from the plan
- Month to month comparative financial statements, such as a rolling 12- month financial statement and comparisons to the previous year

The key financial metrics of the business should be summarized and compared to planned and past results and also to industry standards. This type of concise report to management provides a quick overview of the progress of the business and a guide for the improvements, which must be implemented.

The furniture retailing manager should also be studying those sales and inventory analysis reports, which provide the most complete summary of the key business components – major product category, vendor and salesperson. The fundamental information, provided by the key reports, should include sales, cost of sales, gross margin, GMROI, percentages of the total business, inventory valuation, best seller stock analysis and the aging of in-stock merchandise.

As with the financial metrics, the inventory metrics should also be compared to planned and past results, as well as to the retail furniture industry typical high profit store results.



Strong consideration should be given to the use of graphs and charts to provide management with the most informative analysis of the state and progress of the business.

Access to the information included in these various financial, merchandising and analytical reports must be provided, to allow the furniture retail manager to truly understand the business. The effective use of these key reports will enable the manager to make those important decisions, which will result in the achievement of the organization's objectives.

For information on how you can start to take the steps towards the understanding, and implementation of these five key aspects to the operation of your retail furniture operation, please contact Wayne McMahon at 800-888-5564 or by e-mail – wayne@profitsystems.net.