THE STRATEGIC CFO

KNOW YOUR ECONOMICS

Do you know your company's economics? How many others in your company do you think understand this information?

The CEO and CFO should know them. Ideally, all employees in the company should know how the company makes money.

What does "know your economics" mean?

Pretend we are at a bar having a beer and I ask you to explain to me how your company makes money. If you truly understand your company's economics, you should be able to jot out the following on your cocktail napkin (even after a couple of beers...):

For every $1.00:

Sales	$1.00
COGS	?
Gross Margin	____ _ ?
Overhead	____ _ ?
Net Income	____ _ ?

Think you could do it? If not, you're probably overthinking it. Here's an example...

Our consulting practice has the following economics:

Sales	100
COGS	%
Gross Margin	60%
Overhead	40%
Net Income	30%
	10%

Sounds simple, right?

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Not always. You would be surprised at how few people in your organization really understand how you make money.

Operations very likely could give you the COGS section in their sleep. Your sales force could probably take the calculation down to Gross Margin, but they likely have no idea how much overhead is running.

It's up to you as the financial leader of the company to educate everyone on how much of every dollar falls to the bottom line.

Pricing for Profit

Does your pricing model reflect your economics? It very well might... at least down to gross margin. Few pricing models take into account the cost of running the business (i.e. overhead). Your sales force will tell you that volume will cover overhead, but what if it doesn't?

Consider breaking down the pricing of your products to include overhead. Even if you can't price all your products to be profitable to the net income level, your sales staff will likely be more inclined to get whatever additional pricing they can once they understand the impact.

Financial Statements

You know your economics and have checked your pricing model. Now one of the most important things that you can do is apply all of the above to your financial statements.

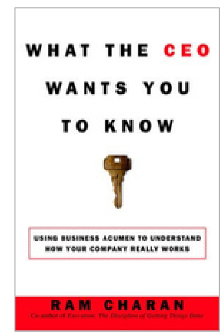
If you've reconfigured your overhead by moving some of overhead up into your cost of goods sold, make sure that economic change has been applied to your financial statements.

This will be the best measure as your assess whether you are in the right place to grow and if that growth is making your company more or less profitable.

Cash Generation

Charan defines cash generation as “the difference between all the cash that flows into the business and all the cash that flows out of the business in a given time period.” Cash is king. Cash is the oxygen to your company. An organization can quickly suffocate by spending money without knowing the effects on the company’s economics.

Ram Charan, the author of “What the CEO Wants You to Know,” claims that every business is identical on the inside. Money making in business has three basic parts: cash generation, return on assets (a combination of margin and velocity), and growth” (p. 29).



Return on Assets

How much profit did you make in the last quarter?

On average, a company earns 10% profit. The real question becomes whether a company needs to make a profit at all if it can cover its costs. There are two reasons why you should worry about making a profit:

1. Profit provides a cushion in desperate times, such as an economic recession. 2. Profit allows you internal financial leverage to reinvest into the company.

Growth

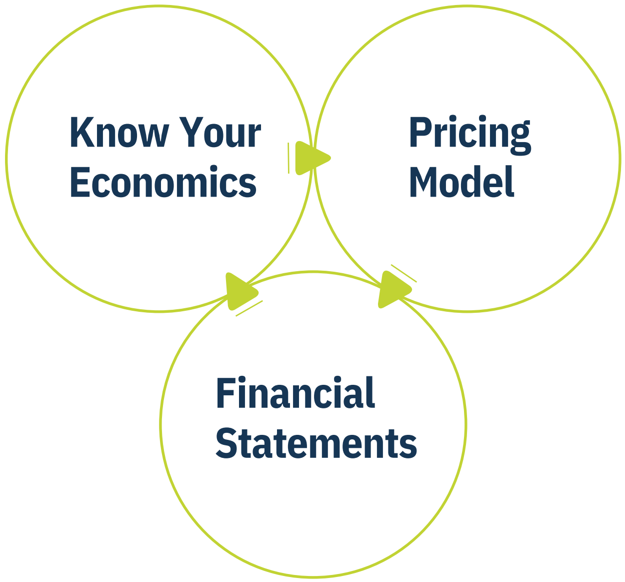
Charan emphasizes, “Growth for its own sake doesn’t do any good. Growth has to be **profitable** and **sustainable**. You want growth to be accompanied by improved margins and velocity, and the cash generation must be able to keep pace” (p. 47).

When considering a growth plan, go back to the basics. It’s an important reminder that just because there is cash in the bank doesn’t mean that growing is in the best interest of your organization.

By restructuring, monitoring, and tweaking your economics when needed, you can increase the value of your company. A 1-2% increase of value in a $40 million business can make a significant difference.

One of our clients owned a $40 million business. The bank referred us to them because of some financial issues they were having. When investigating, we found that they just had bad economics. Although they were bringing in plenty of revenue, their COGS and overhead were too high. Our client hadn’t priced their product correctly to actually make a profit.

By reconfiguring their bad economics, re-pricing their product, and reorganizing their financial statements, we were able to find 1-2% extra cash out of the $40 million. This resulted in $400,000-$800,000 in cash that increased EBITDA, which translated into increased value of the company!



Knowing your economics, strategically pricing your product, and reflecting your economics in your financial statements will give you a significant opportunity to add value to your company.

KNOW YOUR ECONOMICS

"on a cocktail napkin"

THE STRATEGIC CFO

ASSUME YOU BRING IN $ ______________

THE STRATEGIC CFO

Sales	$1.00
COGS	
Consultant	0.60
P/R Taxes	0.06
Expenses	0.05
Total	$0.71
Gross Margin	0.29
Overhead	0.25
Net Income	4 - 5%

YOUR COMPANY

Sales	$1.00
COGS	
______________________	____________
______________________	____
______________________	____________
______________________	____
______________________	____________
Total	____
	____________
	____
Gross Margin	____________
Overhead	____
Net Income	____________
	____