Food Store Money Management

There are seven commonly accepted rules of thumb for better money management in retail food stores. This publication briefly describes each of these rules. References are listed as a guide to further reading.

Food retailers who follow these seven rules of thumb can expect to improve their store's financial performance.

1. Plan for Profit
2. Analyze the Financials
3. Forecast Cash Flow
4. Maintain a Healthy Capital Structure
5. Exercise Control
6. Preserve the Capital Investment
7. Plan for Future Capital Needs

1. Plan for Profit

Some food retailers view profit as "something left over at the end of the year—if they are lucky." While profits are never guaranteed, they are more likely to materialize when planned.

The profit planning process, as illustrated in Figure 1, is a continuing process. It involves:

1. Analyzing a store's existing operations and those of its competitors to determine operating strengths and weaknesses.

2. Determining key performance areas (KPA's), areas that influence store profits: for example, sales, gross margins and expenses.

3. Making realistic projections for each KPA when appropriate.

4. Establishing realistic, timely, and measurable KPA objectives in writing.

5. Building flexible action plans to achieve KPA objectives. Action plans are step-by-step procedures spelling out how the objectives will be achieved within specified time periods.

6. Putting action plans to work.

7. Evaluating the success of action plans by comparing actual results with planned KPA results.

8. Recycling the profit planning process and making adjustments or changes in action plans as needed to achieve KPA objectives.

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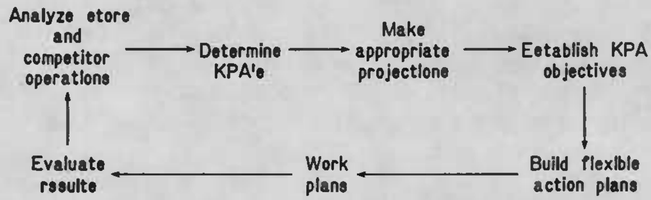

Figure 1. The Profit Planning Process

2. Analyze the Financials

Three fundamental financial statements should be analyzed by a food retailer. These are the balance sheet, profit and loss (operating or income) statement, and statement of changes in financial condition (working capital).

Analysis and interpretation of the information presented in these financial statements should help food retailers:

- Determine the profitability of their operations during specific time periods.
- Project the future ability of their business to service debt requirements and meet the demands of possible expansion and changes in economic condition.
- Obtain information on trends in sales, margins, expenses, and profits as related to the success of past decisions.
- Identify causes of a good or bad financial condition (structure) and of low or high profitability.

• Identify what changes may need to be made to improve the business's financial condition and profitability.

• Compare a store's financial condition and profitability to other similar store operating results.

Food retailers need to analyze current and accurate financial statements to determine where their businesses are at a given point in time with respect to the amount of resources controlled and to determine how well their stores' resources have been used to produce profits.

3. Forecast Cash Flow

Forecasting cash flow is an important part of good money management. It involves preparing a cash-flow budget to estimate the future cash requirements necessary for store operations. Basically, the cash-flow budget involves forecasting all monthly, quarterly, or annual cash receipts and disbursements. It shows when to expect surplus cash and when to expect cash deficits.

The cash-flow budget is one of the most valuable financial planning tools available to food retailers. It can be used to provide information necessary for:

• Making the most efficient use of cash.

• Determining when to finance seasonal cash needs.

• Developing a sound borrowing program.

• Determining the timing of debt repayments.

• Planning the investment of surplus cash in other profitable enterprises.

• Determining when funds may be available for expansion purposes.

Preparation of a cash-flow budget often forces a review of many aspects of a store's operations that might otherwise receive inadequate attention or be overlooked during day-to-day operations.

4. Maintain a Healthy Capital Structure

Food retailers can maintain their capital structure in a healthy condition by giving attention to four basic factors: liqudity, leverage, profitability, and asset usage.

• *Liquidity* involves being able to pay bills on time and when they come due. To a large extent, this involves maintaining an adequate working capital position. Working capital is the amount by which current assets exceed current liabilities, i.e., the owner's equity capital investment in the current assets (cash, accounts receivable, and inventory) of the business. Essentially, it constitutes a cushion for current creditors and can be used to take advantage of trade discounts, expansion opportunities, etc. Profits constitute a principal source of working capital. But working capital also can come from long-term borrowings, additional owner capital contributions, and from the sale of fixed assets such as land, buildings, and equipment. Most food stores, however, are not in business to sell their fixed assets as a means of increasing their working capital. Consequently, in terms of maintaining a liquid position in the business, food retailers should focus attention primarily upon the generation of adequate working capital through profits.

• *Leverage* involves maintaining a reasonable mix between the amount of debt and equity capital in the business. A retail food store whose capital structure is highly dependent upon debt runs the risk of being unable to meet the fixed interest charges associated with the debt, as well as the principal repayment requirements, should a loss be incurred. This is especially so if sales fall off and profits do not materialize as planned. It is important to maintain a reasonable mix between the debt and equity capital structure to help insure the long-run survival of the business.

• *Profitability* involves earning a return on the total capital invested in the store (assets), on the equity capital invested in the store (net worth), and on sales. Food retailers need to establish performance objectives (standards) for each of these three indicators of profitability.

In establishing these standards, retailers should consider the interest rate on borrowed capital, the degree of risk of possibly losing their equity capital investment, the rate of inflation, (especially as it pertains to the cost of replacing depreciable fixed assets), and the opportunity cost of equity capital in terms of what could be earned on the investment of such capital in the next best alternative.

• *Asset Usage* can be indicated by inventory turnover. Asset turnover (sales/total assets) is another indicator of efficiency, and working capital turnover (sales/working capital) is yet another.

In summary, food retailers can help to keep the capital structure of their business healthy by:

• Maintaining the business in a liquid position to be able to meet debt obligations and pay bills on time.

• Maintaining a reasonable and safe mix between debt and equity capital in order to stay in business should an adverse situation arise.

• Achieving adequate levels of return on total capital, equity, and sales.

• Striving for high levels of efficiency in asset usage.

5. Exercise Control

Food retailers must control the financial aspects of their operations if they are to achieve their financial objectives. For example, each of the key performance areas (KPA's) determined in the profit planning process must be controlled. In general, control involves keeping plans on target, on schedule, and taking corrective action or making adjustments when needed to insure accomplishment of a store's objectives.

More specifically, controlling involves the process of measuring actual results and comparing these to planned results. Planned results represent the standards for what should happen if action plans materialize as scheduled. Only when actual results fail to reach planned results, is action taken to correct the deviations. The control process is illustrated in Figure 2. It can be summarized as follows:

- Establish measurable performance standards (planned results) for each KPA.
- Measure actual KPA results.
- Compare actual results to standards (planned results).
- Take action to correct deviations when actual results are not within acceptable tolerance levels for each KPA standard.

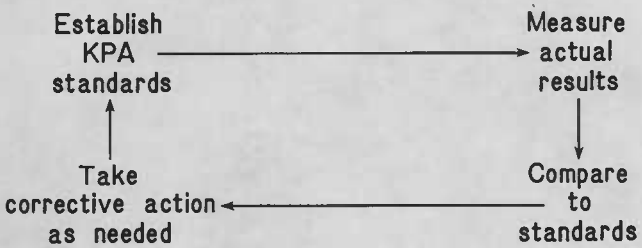

Figure 2. The Control Process

Food retailers should operate by the principle of management by exception when applying the control process. This requires establishing an acceptable performance range for each KPA standard. Actual results may then be allowed to fluctuate within this range without the need to take corrective action. Only when actual results move out of a predetermined performance range would corrective action then be taken.

In summary, exercising control is the means by which a store's action plans are implemented and objectives are accomplished.

6. Preserve the Capital Investment

Food retailers should be aware that preserving the capital investment they make in their businesses is just as important a money management matter as any other they must deal with. Failure to take precautionary measures to preserve their investment could result in many undesirable consequences. The worst consequence is going out of business or, in some instances being unable to insure a smooth transfer of the business to heirs. There are many ways to preserve the capital investment in a store. Here are some that food retailers should consider:

- Maintain adequate business and liability insurance coverage.
- Establish a legal business entity (i.e., corporation).
- Implement on-going employee management development training programs.
- Plan for transferring the business.
- Diversify into other areas of operation to spread business risks when appropriate.

Food retailers should seek alternatives continually for preserving their capital investment. Now may be an appropriate time to begin identifying and correcting any existing deficiencies or oversights.

7. Plan for Future Capital Needs

Planning is an important aspect of money management, whether it be to obtain capital needed to increase inventories, remodel a store, acquire new facilities, replace equipment, or to diversify into new areas of operation. The capital-needs planning process involves determining:

1. How much capital is needed.
2. When it is needed.
3. What kind should be borrowed or obtained (such as short-term debt, trade credit, long-term debt, or owner equity capital additions).
4. Where it can be obtained at the best terms (such as from commercial banks, mortgage companies, insurance companies, private lenders, lease arrangements, or through additional ownership capital contributions).
5. How it will be repaid (which can be projected through the preparation of a cash-flow budget).

When planning for future capital needs with respect to securing debt capital, it is important not be become overly indebted or borrow more than is required to effectively operate a store. In part, this involves maintaining a good working relationship with a retail food store's banker or providers of financing. It also involves accurately forecasting cash flow requirements.

Recommended Reading List

Downey, David W. and Marten, John F. *Principles For Profit*. Agricultural Economics, Purdue University (mimeographed).

Swick, Jack. *A Handbook of Small Business Finance*. Small Business Management Series No. 15 (Seventh Edition), U.S. Small Business Administration, Washington, D. C. (1965).

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