Focus Four™

Small Business Field Guide

America's SBDC Michigan

Grand Valley State University

Michigan Economic Development Corporation

Powered by SBA U.S. Small Business Administration

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VISION STRATEGY EXECUTION CASH FLOW

What is Focus Four™?

And why should you care?

The numbers are sobering. Of the hundreds-of-thousands of new businesses that are started every year, only about ½ will survive to see their fifth anniversary and only about ½ of those will make it to their tenth. In addition, only a very small fraction will surpass the million-dollar revenue barrier. Worse, the majority of surviving small businesses – even those that have managed to break the million-dollar barrier – don't earn enough to economically justify their existence: Their owners are continually deferring their pay, sacrificing their health, and/or working the equivalent of two or three jobs just to keep the company afloat. We want to change that.

Focus Four™, while not a magic bullet, is designed to address all of those issues and more. Specifically, the program has been designed to help small business owners:

- ✓ Grow their businesses faster, and with less chaos,
- ✓ Improve their businesses' profitability,
- ✓ Elevate themselves to a more strategic (and less frantic) role, and
- ✓ Build more value in their companies.

Small business owners seeking significant growth face a unique set of challenges. Challenges that must be met if their businesses are to reach their full potential.

The first challenge involves a shift in owner mentality, from working in the business to working on the business (see sidebar); from doing and/or directing pretty much every activity within the business to leading and inspiring a team to do the work that's required to meet customer demands; from owning a job to owning a business.

The second challenge involves building an effective infrastructure – from developing and communicating a Vision that inspires employees and customers alike, to developing a strategy that provides a sustainable competitive advantage, to putting formal systems and processes in place to ensure that everyone is enthusiastically doing the right things right.

The third challenge involves managing capital. Small business owners most often have limited sources of external financing. As such, they must learn how to accurately forecast their capital needs, maximize operating cash flow, and deploy cash in ways that are expected to provide significant returns – returns that will fuel future growth and provide significant rewards to the company's stakeholders.

Focus Four™ is designed to help small business owners meet all of these challenges. Based upon proven principles that have stood the test of time, Focus Four™ is, quite simply, a compilation of world-class tools and ideas developed by some of the best-and-brightest business minds on the planet.

While this field guide is written in DIY format, we strongly encourage anyone who decides to implement Focus Four™ to engage one of the Small Business Development Center's (SBDC) experienced Focus Four™ facilitators. Implementation assistance, like all of the SBDC's consultative services, is available at no-cost. Our intent is not to compete with alternative systems but, rather, to provide assistance to those who can't afford $5,000 per day consultants.

"ON" vs. "IN"

In 1986, Michael Gerber published one of the most profound small business books ever written: The EMyth: Why Most Small Businesses Fail and What To Do About It. In it, Gerber insightfully distinguishes between working in a business and working on a business:[1]

- Most small businesses are started by people who are expert at a particular technical skill (e.g., making pizza or coding computers or machining metals).
- These "technicians" fatally assume that understanding the technical work of a business is the same as understanding how to run a business that does the technical work.
- The result is that the technician-turned-business-owner spends the majority of his time working in the business (making and delivering product) and very little time working on the business (setting strategy, developing systems, integrating, leading and inspiring).
- Which severely limits the business's ability to scale, to generate profits beyond some basic "wage", or to create value in the business that could someday be monetized.
- In other words, the technician-turned-business-owner hasn't really created a business at all. He's simply created another job for himself - one that often pays half as much (for twice the work) as he could earn working for someone else.

So, what the heck does Focus Four™ look like?

Graphically, it looks like this:

Four core focuses, each with three key modules, all designed to comprehensively work together to significantly strengthen growing businesses (or businesses that are struggling to grow). Yes, there's a lot to digest and, yes, implementation will require discipline, time and commitment. But the results can be well worth the effort. If well-implemented, small business owners should see steady improvements in their organizations' ability to accomplish their most important goals and break through the many barriers to growth and profitability that they will face over time.

Before diving into Focus Four™, though, take a few minutes to complete and score the self-assessment on the next page. This assessment will give you a good idea of your organization's current strengths and weaknesses, and will serve as the baseline by which to measure future operational improvements.

Focus Four Self-Assessment

Vision

1. We have an inspiring ***Core Purpose*** that is widely and frequently communicated throughout the organization. YES ☑ NO ☐
2. Our ***Core Values*** are well-defined, action-oriented and enforced. We use them as the basis for all of our personnel decisions (e.g. hiring, performance reviews). YES ☑ NO ☐
3. We have a compelling ***Vision*** of our long-term future – what the company might look like in 10 to 15 years if everything went exactly as planned. YES ☑ NO ☐

Strategy

1. We fully understand the ***Competitive Environment*** in which we operate, and our strategy reflects the reality of that environment. YES ☑ NO ☐
2. We also have a deep understanding of our ***Position*** within that environment and the factors that will drive our success. YES ☑ NO ☐
3. We have quantified our ***Strategy***, including 1- and 3-year revenue and income goals and corresponding priorities/key assumptions. YES ☑ NO ☐

Execution

1. We have an up-to-date ***Responsibility Chart*** and continuously strive to put the right people in the right seats. YES ☑ NO ☐
2. We have a formal ***Leadership Process*** in place that ensures that the majority of our goals are met and our weekly to-dos consistently become to-dones. YES ☑ NO ☐
3. We have identified and documented our ***Core Systems and Processes*** and we regularly review them for improvement opportunities. YES ☑ NO ☐

Cash Flow

1. Our Leadership Team has a solid understanding of the three foundational ***financial statements***: Balance Sheet, Income Statement and Statement of Cash Flows. YES ☑ NO ☐
2. We understand and actively manage the eight cash flow ***Impact Drivers*** including short- and longer-term forecasting (aka budgeting). YES ☑ NO ☐
3. Our financial decisions are made within the context of return-on-investment and business ***Value Creation***. YES ☑ NO ☐

About You and Your Company

	Last Year	This Year
1. Annual Sales	________	________
2. Number of Employees	________	________
3. Dollars Spent on Significant Expansion Projects	________	________

4. In a few words, describe your most significant business concern/challenge.

Table of Contents

How to use this Field Guide vi

Rules of the Road ix

The Focus Four™

First: VISION. 1

Second: STRATEGY 13

Third: EXECUTION 35

Fourth: CASH FLOW 65

Appendix

Value 102

Bank Financing 107

About the Michigan SBDC 109

Footnotes 110

How To Use This Field Guide

The purpose of Focus Four™ is to help you bring alignment, accountability and scalability to your organization. If well implemented, you should see marked improvement in your business's ability to grow and prosper. As mentioned previously, most of the ideas contained herein aren't new or proprietary to the SBDC. They're proven, time-tested concepts that, quite simply, work.

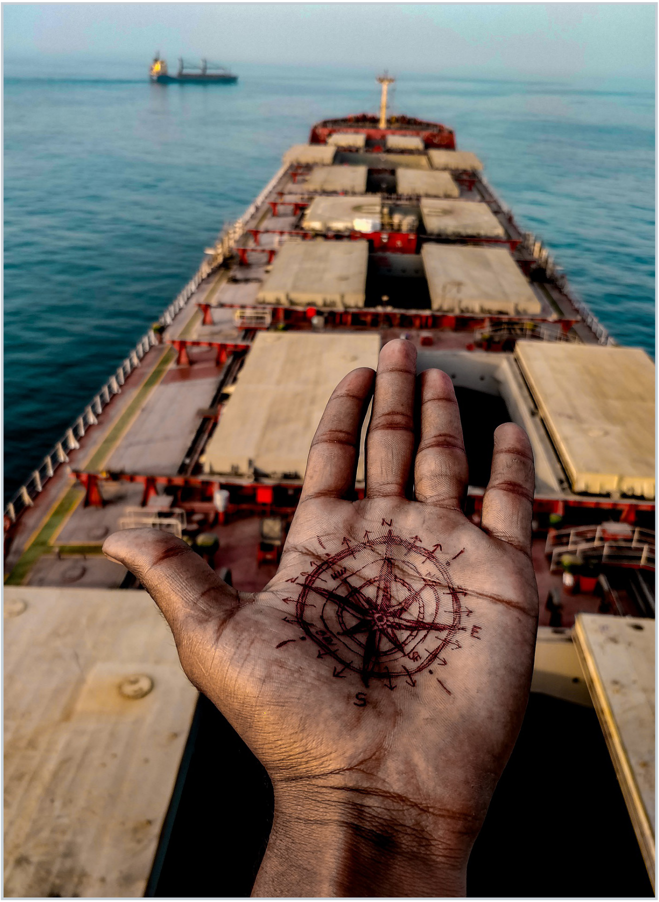
While Focus Four™ is designed to be modular, we strongly recommend that you work from the top down. You'll experience the best results if you start with the Vision component, then go to the Strategy component, then Execution and, finally, Cash Flow. The primary exception to this rule would be if your firm is experiencing a significant cash crunch. If that's the case, start with the Cash Flow component followed by the Execution component.

Focus Four™ is designed so that it can be self-implemented, and this Field Guide assumes a team-oriented do-it-yourself approach. The team should consist of whomever you consider to be a part of your "Leadership Team" (LT). Typically, the LT will be comprised of you, the owner, and the people who are responsible for the core business functions (e.g., Sales, Operations, and Accounting). The two possible exceptions to team involvement would be during the development of your business's Core Purpose and Core Values (the first two parts of the Vision component). Those sometimes come directly from the owner, especially for relatively new companies. On the other hand, team involvement during goal-setting is imperative. You will not get great buy-in or accountability if the team isn't involved in the goal-setting process.

Important Note #1: While this Field Guide is designed with "do it yourself" in mind, you will get the best results if implementation is facilitated by an SBDC Consultant. There is great value to having an objective, 3rd-party participate in the process.

Important Note #2: While Focus Four™ is effective for both product and service organizations, we only refer to products in this Field Guide. There are two reasons. First, it keeps the text more readable (than constantly writing "products and/or services"). Second, and more importantly, your service business will be easier to manage, generate more cash flow and, ultimately, be more valuable if you can "productize" the service(s) you offer. For a great illustration of how to turn a service offering into a scalable product, we recommend John Warrilow's book, Built to Sell: Creating a Business that can Thrive Without You.

Important Note #3: Focus Four™ is effective for both business-to-business (B2B) and business-to-consumer (B2C) companies. Some of the examples in this workbook are B2B-related and others are B2C-related. The examples are not meant to be exclusionary. In other words, if a certain principle is accompanied by a B2B example, that does not imply that the principle isn't just as applicable in a B2C environment.



Important Note #4: All of the worksheets that are referred to in this guide have been compiled into a handy "Field Kit" which can be downloaded here.

Finally, as you work through the Vision and Strategy sections, you'll want to complete the Company Compass®. The Company Compass® is a one-page summary of the key strategic decisions you'll make as you work through the process; decisions that will form the basis for your plan of execution and your company's ability to generate cash flow. Once completed, it will help you and your team stay focused on your "North Star", so that you can steadily move in the right direction.

Sample Company Compass: Mike's Guitar Shop

VISION

Core Purpose

To transform wood and metal into the most responsive musical instruments in the world.

10-Year BHAG®

To get one of Mike's guitars into the hands of every living guitarist who's had a top-10 recording.

Core Values

Do the Right Thing
What do you do when no one else is looking? We will always act with integrity and honesty, and focus on putting ourselves in others' shoes.

Get'er Done!
Clients trust us to build things that work and we take that seriously. Our team will overcome obstacles, find solutions and deliver exceptional musical instruments.

Make a Difference
We constantly push ourselves to be our best, we focus on solutions, and we arrive every day inspired to make an impact through our talents, passion and hard work.

Be an Ambassador
We are proud of our creations and take every opportunity to demonstrate their desirability to our customers, partners, and community at large.

Play for Each Other
Above all, we're a team. That means we show up for each other, act with empathy, and bring our authentic selves

STRATEGY

Core Product

Hand-crafted electric guitars.

Ideal Customer

Males, ages 30 to 60, earning at least $40,000 per year who are either professional (working) musicians, home hobbyists or collectors.

Desire for affinity or desire to own "the one" guitar that can do it all tonally and stylistically.

Active PayPal account or credit score of at least 650.

Differentiations

- *100% made in USA.*
- *Hand-wound pickups.*
- *Patented compound neck shape.*
- *Select woods sourced solely from managed (renewable) forests.*
- *Endorsed by SRV, Jimi Hendrix, and Terry Kath.*

Brand Promise

- *Simply the Best.*
- *30 day, no questions asked, money-back guarantee*

Long-Term Plan

	LAST YEAR	NEXT YEAR	INC/ (DEC)	3 YEARS OUT
SALES/ REVENUE	$1.85M	**$2.22M**	$0.37M	$2.94M
GROSS PROFIT	$0.88M	**$1.13M**	$0.24M	$1.49M
GPM (%)	48.0%	**51.0%**	3.0%	51.0%
OPERATING PROFIT	$161,000	**$207,200**	$46,200	$287,335
OPM (%)	8.7%	**9.3%**	0.6%	9.8%
INVESTED CAPITAL	$1.34M	**$1.54M**	$0.2M	$1.64M
ROIC%	12.8%	**18.0%**	5.2%	21.0%

Critical Assumptions/Strategic Priorities

1 Year

- *Establish West-Coast Distribution Center by May 31st.*
- *Line 7 scrap rate is reduced by 50% no later than December 31.*
- *Hire Marketing Director by September 30.*
- *Roll-out "Cutlass"*

3 Year

- *Expand production capacity by 50%.*
- *Establish European Distribution Center.*
- *Document all Core Systems and Processes.*

Rules of the Road

Implementation of any business system is rarely an easy task. It takes time, discipline and a significant level of commitment. The payoff, however, can be enormous: In general, we've found that companies who are "powered by" an effective Small Business Management System ("SBMS") grow faster with less chaos, generate more cash flow, are more valuable, and have a far more harmonious work environment. But getting from Point A (running your business without a formal SBMS) to Point B (full alignment and focus across the entire organization) can be challenging, even in the best of circumstances. Change is hard. To make your journey as smooth as possible, keep the following "Rules of the Road" in mind:

1. **Commit!** The journey can, at times, be frustrating but it will be worth your while. At this point, all we can do is ask you to trust the process and remind you that Focus Four™ is based on proven, time-and-battle-tested concepts.

2. **Be Patient.** Despite our best efforts to keep Focus Four™ reasonably simple, implementation will require a lot of thoughtful discourse and, sometimes, deep rumination. Don't rush the process.

3. **Be Forthright.** With yourself and others. For Focus Four™ to be effective, you'll need brutally honest assessments of yourself as a leader, your team's fit in terms of its competencies and values, and your company's strengths and weaknesses versus its competitors.

4. **Learn to Be Humble.** Humility is broadly defined as 1) self-awareness, 2) the ability to appreciate others' strengths and contributions, and 3) being open to new ideas and feedback regarding one's performance. Humble leaders readily admit their mistakes, share credit, and learn from others. They foster a culture of openness, trust and recognition, focusing on team performance and viewing themselves as coaches rather than managers.

5. **Look for Opportunities to Simplify.** As organizations grow, they become more complex. Complexity breeds chaos and chaos can destroy a company's ability to execute. As you work through Focus Four™, continually keep an eye out for opportunities to simplify. While it's easy to get into the weeds and chase every issue to the nth degree, remember the old adage, "Less is More!".

6. **Look for Opportunities to Delegate.** The most successful business leaders free themselves to work "on" their businesses by building highly competent teams and delegating core responsibilities to them. Don't spend your time on tasks that others can do just as well (or better) at less cost.

7. **Create a Binder.** For each member of your Leadership Team, create a binder with the following five sections:

    Section I – for your Compass®, Scorecard, Rocks, Weekly Commitments.

    Section II – for your Financial Information

    Section III – for your Systems and Process Documentation.

    Section IV – for all of your supporting documents (e.g., SWOT, ICP, Competitor Profile)

    Section V – for a printed copy of Focus Four™ (optional).

8. **Ask for help.** The Michigan SBDC's core purpose is to help small businesses grow and thrive. There are few, if any, Michigan-based organizations that have the collective experience, or depth and breadth of small business-related knowledge, of our state-wide network of consultants. **Register for no-cost, confidential 1:1 consulting today at https:/sbdcmichigan.org.**

Focus 1 – Vision

Focus 1 – Vision

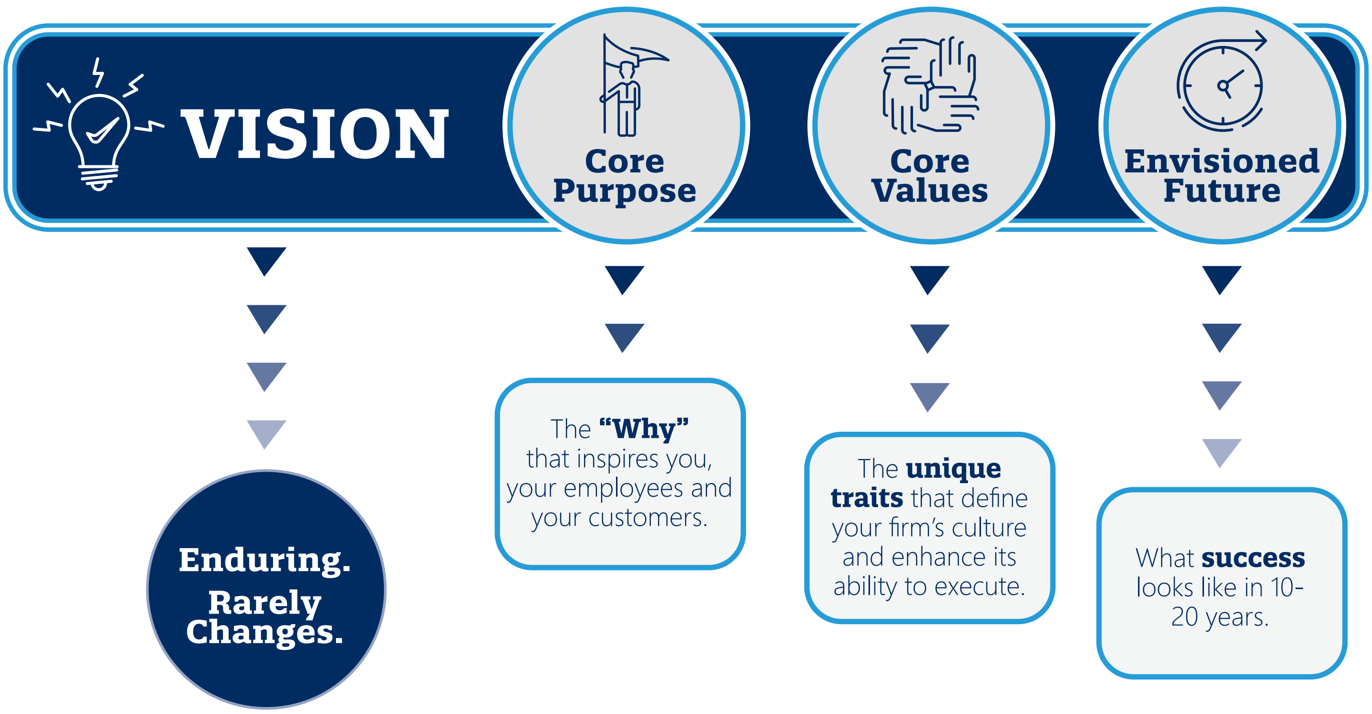
"The greatest danger is not that we aim too high and miss it, but that we aim too low and hit it."

Michelangelo

The need for businesses to have an enduring Vision was solidified by Jim Collins and Jerry Porras in their book Built to Last: Successful Habits of Visionary Companies. During their research, they discovered that the most successful companies had a rarely-changing Vision which served to align the organization and stimulate continued progress towards its aspirations. As Collins notes: "A deeply held <Vision> gives a company both a strong sense of identity and a thread of continuity that holds the organization together in the face of change."[2]

Collins' and Porras' findings have been repeatedly verified; most recently, perhaps, by serial entrepreneur Ryan Westwood who surveyed 100,000 successful small business owners in an attempt to determine if there were any common attributes that drove their success. In The Five Characteristics of a Successful Entrepreneur, Ryan reports that a majority of respondents identified Vision as the single most important characteristic for their success.[3]

Vision is not about the money. Vision is about alignment and inspiration: It's about getting everyone in an organization to not just row in the same direction, but to enthusiastically row in the right direction. As defined by Collins and Porras, Vision is comprised of three components: Core Purpose, Core Values, and an Envisioned Future (which is often referred to as a BHAG® or Big Hairy Audacious Goal):



Core Purpose

Your business should be a means to an end, a vehicle to enrich your life rather than drain it. It is a product of your life plan: It must serve you. Ask yourself: What do you want your life to look like? What do you value most? What are you passionate about? What inspires you? What is the ultimate *personal* return that you want from this investment of time, money and mental energy? Mull over these questions until you have a deep understanding of your personal goals and motivations. You might want to use the worksheet that can be found here.

Now ask yourself: What *non-monetary* benefit will your business bring to the world, including your employees and customers, that aligns with your personal goals and passion? Are you building a "lifestyle" company, or do you want to change the way an entire industry does business (or are you attempting to create an entirely new industry)? In other words, what's your company's "WHY" – why does/will/should your business matter to you, your employees and your customers?

Your company's Core Purpose should be bigger than the money, its people or its product offerings. It should be a belief that underlies and drives *everything* your company does. As Simon Sinek notes in his book *Start with Why* (a short video summary can be found here), your company's ability to truly prosper isn't as much about what you sell as it is about *what you believe; your company's raison d'être, its "WHY"*.[4]

The Golden Circle

WHAT

Every organization on the planet knows ***what*** they do. These are the products they sell or the services they offer.

HOW

Some organizations know ***how*** they do it. These are the things that make them special or set them apart from their competition.

WHY

Very few organizations know ***why*** they do what they do. WHY is not about making money. That's a result. WHY is a purpose, cause or belief. It's the very reason your organization exits.

As noted in the accompanying "Golden Circle" illustration, relatively few companies understand their Core Purpose. Yet, if carefully crafted, your Core Purpose will inspire you, your employees, and your customers. For you, it will serve as a constant source of passion – a reminder that the long hours, constant stress, and sacrifices are *worth it*. Your employees also want to know that at the heart of what they do is something meaningful, something bigger than their paycheck; that what they do for a living serves a greater purpose.

Studies have shown that employees who understand and believe in the *WHY* are more engaged, more self-motivated and are almost 5 times more likely to feel empowered to perform their best work[5].

Like your employees, your customers also want an emotional reason to connect with your company. They want to know why they should do business with you rather than your competitors, and they want *the why* to be more than just a set of product features. A purpose-driven brand – a brand message that gets to *the why* – will create and inspire enthusiastic advocates who are personally invested in your company's success.

"If Core Values are the soul of an organization, Core Purpose gives it heart."

Verne Harnish

Defining your Core Purpose is all about authenticity. If it's not genuine, if it doesn't ultimately permeate every aspect of your business, and if it's not easily understood *at the gut level* it will fail to inspire. As such, Core Purpose is not a "Mission Statement" full of platitudes and clichés that are neither memorable nor inspiring. Nor is it a tag line. A true Core Purpose is genuine, forthright, and truly meaningful. You'll know when you've identified it because it will be accompanied by a strong sense of conviction.

Identifying your Core Purpose may be easy, or it may take some soul searching. If you already think you know what it is, pull out the second Core Purpose worksheet now and see if it passes the "Jim Collins" test[6]. If it does, congratulations! Share it with your Leadership Team, get their feedback (does it excite them?), tweak it as you see fit, and transfer it to your Company Compass®.

If you're not sure what your Core Purpose is, here are some examples from some of the most successful companies on the planet:

Company		Core Purpose
3M	▶	To solve unsolved problems innovatively.
Google	▶	To organize the world's information and make it universally accessible and useful
Nike	▶	To experience the emotion of competition, winning, and crushing competition
Sony	▶	To experience the sheer joy of advancing technology for the benefit of the public.
Verizon	▶	To enable people and business to communicate with each other.
Walt Disney	▶	To make people happy.
Patagonia	▶	To protect life on earth from the threat of extinction.

Sketch out some ideas on the first Core Purpose worksheet. Try to create a memorable phrase – no more than a dozen words or so. As you start getting close to something that feels right, move on to the second Core Purpose worksheet to see if it passes the Jim Collins test. If it doesn't, keep working it until it does. Once you and your team (and Jim!) are happy with the result, transfer it to your Company Compass®.

Core Purpose Worksheet (#1 of 2)

Use this space to capture your thoughts about your business's Core Purpose.

Your Core Purpose must be authentic: It should inspire you, your employees and your customers. It is not about the money!

It's about the WHY!

Core Purpose Worksheet (#2 of 2)

Write your draft core purpose here.

Make it as concise and memorable as possible.

Now, answer these questions[7]:

1. Do you find this purpose personally inspiring?	YES	☐	NO	☑
2. Can you envision this purpose being as valid 100 years from now as it is today?	YES	☐	NO	☑
3. Does the purpose help you think expansively about the long-term possibilities and range of activities the organization can consider over the next 100 years, beyond its current products, services, markets, industries, and strategies? (For example, Disney's purpose to make people happy helped propel the company from its initial strategy of cartoons into full-length feature animation, the Mickey Mouse Club, Disneyland, EPCOT Center, and so on.)	YES	☐	NO	☐
4. Does the purpose help you to decide what activities to not pursue, to eliminate from consideration? (For example, HP would not pursue markets where there are no opportunities to make a technical contribution.)	YES	☐	NO	☐
5. Is this purpose authentic —something true to what the organization is all about—not merely words on paper that "sound nice"?	YES	☐	NO	☐
6. Would this purpose be greeted with enthusiasm rather than cynicism by a broad base of people within the organization?	YES	☐	NO	☐
7. Would this purpose be greeted with enthusiasm rather than cynicism by a broad base of people outside the organization?	YES	☐	NO	☐
8. When telling your children and/or other loved ones what you do for a living, would you feel proud in describing your work in terms of this purpose?	YES	☐	NO	☐

Once you're able to answer "Yes" to all of the above questions, transfer your **Core Purpose** to your **Company Compass**.

Core Values

In his book, *Good to Great: Why Some Companies Make the Leap... and Others Don't*, Jim Collins notes that the most successful companies prioritized, above almost everything else, getting "the right people on the bus, the right people in the right seats, and the wrong people off the bus." He further notes that 1) if you have the right people on the bus, they'll be self-motivated and the problem of how to manage them largely goes away, and 2) if you have the wrong people on the bus, it doesn't matter what you do – you're unlikely to ever have a great company.[8]

Finding the right people is a not-so-simple matter of finding people who share your Core Values and believe in your Core Purpose. Yes, technical skills are important, but cultural fit is even more important. In fact, it's far more important: People can learn new technical skills, but it's rare that they can change what they intrinsically value and care about. In the words of business guru Peter Drucker, "Culture eats strategy for breakfast."

That values-driven companies achieve better performance continues to be validated by a growing body of research. In addition to having a self-motivated workforce, companies with strong Core Values usually enjoy a distinct recruiting advantage, lower turnover, higher employee satisfaction, more resilience when dealing with crises as well as a built-in branding mechanism that can significantly enhance the desirability of their product to their target market (think Apple Computer, or Ben & Jerry's ice cream).

CORE VALUES n.

A set of beliefs that, along with core purpose, guide a firm's decisions, unite its employees and help define its brand.

Many small companies attempt to identify a list of Core Values at a very early stage in their development. Rarely, however, does that early list of aspirational values survive the test of time. While those Core Values may be posted all over the office in pretty info-graphics, most small companies haven't done what needs to be done to maintain them. So, their cultures develop on their own, often in unexpected (and, sometimes, unwanted) ways. Most problematic, however, is that aspirational values – stated values that aren't lived and breathed every hour of every day by the company's leadership – are likely to create company-wide cynicism. You may say that you value (to the core) openness and honesty, but if your behavior demonstrates otherwise, you'll simply create distrust and confusion.

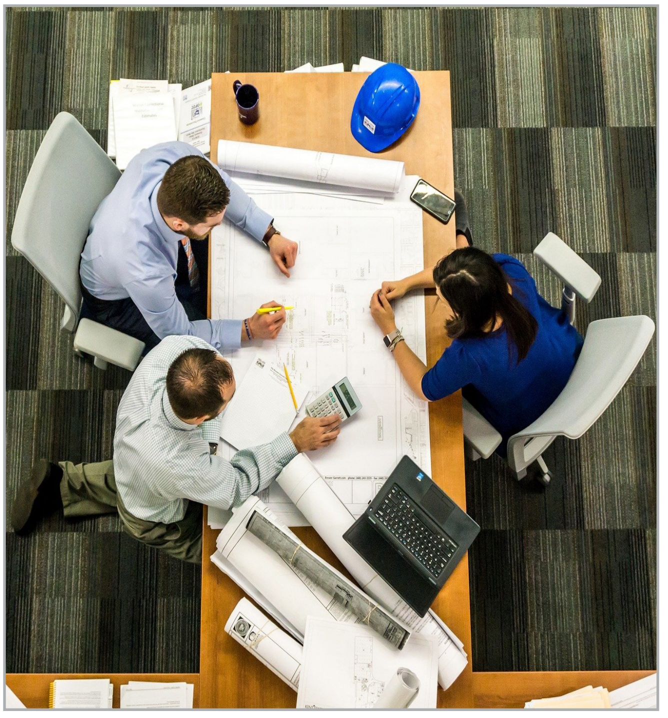
As Patrick Lencioni notes in his must-read Harvard Business Review article, *Make Your Values Mean Something*[9]:

> *"Most values statements are bland, toothless, or just plain dishonest. And far from being harmless, as some executives assume, they're often highly destructive. Empty values statements create cynical and dispirited employees, alienate customers, and undermine managerial credibility."*

He goes on to say:

> *"Values can set a company apart from the competition by clarifying its identity and serving as a rallying point for employees. But coming up with strong values—and sticking to them—requires real guts. Indeed, an organization considering a values initiative must first come to terms with the fact that, when properly practiced, values inflict pain. They make some employees feel like outcasts. They limit an organization's strategic and operational freedom and constrain the behavior of its people."*

Identifying that true, authentic list of Core Values – those deeply ingrained principles that will guide all of your company's actions; the ones you and your best employees live by *without exception*; the ones that are truly unique and set you apart from your competitors; and the ones that you want to perpetuate – is usually a process of discovery.



The discovery process is relatively straight-forward. First, have everyone on your team (including yourself) make a list of three to five people who they've thoroughly enjoyed working with at some point during the past 5 years: People who were both effective at their work and a joy to be around. Don't think about technical skills – think about inherent traits and behaviors that you admire and/or believe are necessary for "next level" success (however you define it).

Next, ask each team member to read their list of values out loud (not names, just values), and write them all on a whiteboard. At this point, you should have a fairly long list of values candidates. The challenge, now, is to whittle this list down to a small handle of truly core values – values that are closely held by each member of your team. To do so, use a process we call "Fuse, Lose or Use":

1. **Fuse** – Start by combining as many similar values as possible. Keep track of the number of times you merge similar items into a single line. The higher the number of merges, the more likely the value is truly core.

2. **Lose** – Then, determine which of the remaining values clearly aren't shared by a majority of team members. Erase them. If you're left with more than five or six values, continue to "fuse and lose" until only a handful remain.

3. **Use** – The remaining values likely represent values that are truly core to your Leadership Team. Use them as the basis for your three to six Core Values.

As you're whittling your list down to a small handful of Core Values that are uniquely yours, keep the following in mind:

- Don't settle for common phrases like "accountable" or "driven". Go for unique, verb-oriented phrases like "Gets the job done, on time, every time." To, once again, quote Simon Sinek:

  "For values or guiding principles to be truly effective they have to be verbs. It's not "integrity," it's "always do the right thing." It's not "innovation," it's "looks at the problem from a different angle." Articulating our values as verbs gives us a clear idea . . . of how to act in any situation. We can hold each other accountable to measure them or even build incentives around them."[10]

> ***"The right people are the ones who share your company's core values. They fit and thrive in your culture. They are people you enjoy being around and who make your organization a better place to be."***
>
> **- Gino Wickman**

- Also, avoid pay-to-play statements like "honest" or "strong work ethic", unless those are truly rare characteristics within your industry.

- And, finally, avoid aspirational values whenever possible. Aspirational values can be very difficult to ingrain, especially in larger organizations.

If you're struggling to write truly unique, impactful Core Values, you'll find a lot of examples (some better than others) here. We happened to like Campminder's:

- ✓ **Put Team First.** With empathy and humility, we seek win-for-all solutions.
- ✓ **Own It.** We hold ourselves accountable for outcomes, good and bad. We don't pass the buck.
- ✓ **Be Admirable.** We honor our word and choose candor, respect and kindness.
- ✓ **Find a Better Way.** We believe in a culture of innovation and continuous improvement. We constantly seek personal and professional growth.
- ✓ **Give Joy. Laugh.** Be grateful, positive and hospitable. Make people feel good.

Jim Collins has a very stringent test for whether a value is truly core. If it is, at least 2/3 of your Leadership Team should be able to answer "yes" to all of the questions on the worksheet that follows[11]. In our experience, few Core Values lists fully pass this test, but it vividly demonstrates the importance of identifying non-aspirational values that are truly core to your team; values that can serve as the cornerstone of all your company's actions – even (especially!) at the cost of convenience or short-term economic gain.

Once you've settled on a list of Core Values, don't tattoo them on your forearm just yet (yes, we have a client who did just that). Try them on for a while, see how they feel and then, when you're 100% certain you've nailed them – that you and your Leadership Team can truly live them – add them to your Company Compass® and weave them into every aspect of your organization. From this point forward they should form the basis for all of your people decisions (e.g., hiring, firing and performance appraisals).

Core Values Worksheet

Write your proposed core values here ______________________

____

____

Now, answer these questions:

1. If you were to start a new organization, would you build it around this core value regardless of the industry? YES ☐ NO ☐

2. Would you want your organization to continue to stand for this core value 100 years into the future, no matter what changes occur in the outside world? YES ☐ NO ☐

3. Would you want your organization to hold this core value, even if at some point in time it became a competitive disadvantage—even if in some instances the environment penalized the organization for living this core value? YES ☐ NO ☑

4. Do you believe that those who do not share this core value—those who breach it consistently—simply do not belong in your organization? YES ☑ NO ☐

5. Would you personally continue to hold this core value even if you were not rewarded for holding it? YES ☐ NO ☐

6. Would you change jobs before giving up this core value? YES ☐ NO ☐

7. If you awoke tomorrow with more than enough money to retire comfortably for the rest of your life, would you continue to apply this core value to your productive activities? YES ☐ NO ☐

If at least 2/3 of your team can't honestly answer yes to each of the seven questions, you've probably not identified a value that is truly core.

Envisioned Future

Another key concept developed by Jim Collins is the idea of an **Envisioned Future or BHAG® ("Big Hairy Audacious Goal"**[12]**)**. The purpose of a BHAG® is to stimulate progress, to give you and your team something, well, big, hairy and audacious to strive for. Something that's "out of reach, but not out of sight". Collins suggests that the odds of hitting your BHAG® should be no greater than 70% and no less than 50%.

As Collins notes[4]: "… a true BHAG is clear and compelling and serves as a unifying focal point of effort—often creating immense team spirit. It has a clear finish line. A BHAG engages people— it reaches out and grabs them in the gut. It is tangible, energizing, highly focused. People "get it" right away; it takes little or no explanation."

Examples of powerful BHAGs® include:

- ✓ Kennedy's proclamation that we'd be going to the moon within a decade.
- ✓ Edmund Hillary's declaration that he was going to climb to the summit of Mt. Everest.
- ✓ Nike's stated goal that it would "crush Adidas".

Unlike Core Values and Core Purpose which, once they've been "nailed", should rarely if ever change, your BHAG® will change on occasion – either when you've reached the goal or when the competitive environment changes so much that your BHAG® becomes obsolete. The point isn't to be perfectly prescient but, rather, to *create a clear, compelling and imaginative stretch goal that fuels progress.*

Get to Work

To determine your BHAG®, ask yourself what "wildest dreams" success looks like within your chosen timeframe (we recommend a 10- to 15-year time frame). Then, ask yourself:

- ✓ Is it something that you can enthusiastically chase, despite less than favorable odds?
- ✓ Is it truly a stretch goal? Does it get your juices flowing but, at the same time, make you a bit nervous when you think about what it would take to attain?
- ✓ Is it "out of reach, but not out of sight"?

Remember – keep your BHAG® simple, concise and memorable. This isn't a wordsmithing exercise, it's an audacious goal that can be stated in just a handful of words.

Once you've discovered your BHAG®, transfer it to your Company Compass®.

Sharing Your Vision.

At this point, it's time to start thinking about how you will communicate your Vision to your entire organization. As we noted earlier, the primary reason for creating your Vision is to get everyone not just rowing in the same direction, but *enthusiastically* rowing in the *right* direction 100% of the time.

The *starting point* is a company-wide speech to introduce your purpose, values and envisioned future. We recommend that you first introduce the why (Core Purpose), then *the where* (BHAG®), and, finally, *the who* (Core Values). Your speech should paint a strong, memorable image of each component. For example, even though your BHAG® is concisely stated on your Company Compass®, paint a picture of how you might actually accomplish it (think of JFK's moon speech). Similarly, you should provide plenty of examples of how people within your organization are living your Core Values. This post has some great ideas for making your Core Values come to life.

We emphasized the words "starting point" because that's exactly what the Vision Speech is. For your Vision to truly take hold, you're going to need to frequently reinforce it. Remember the Rule of 7: People – be they customers or employees – need to hear a message 7 times before it really sinks in. And you'll need to reinforce it more than that during the next several years. As one executive noted when asked what the secret to his success was: "I essentially spent the last 6 years repeating myself."[13]

Your Company Compass: Focus 1

VISION

Core Purpose:

Core Values:

10-Year BHAG®:

Focus 2 – Strategy

Focus 2 – Strategy

> **"In business, I look for economic castles protected by unbreachable moats."**
>
> **Warren Buffet**

Core competencies. Differentiating activities. Niches. Target markets. Customer Value Propositions. It all sounds so formal; so mind-numbingly complex. So *corporate*. Yet nailing these variables is absolutely essential for sustained, above-average growth in revenue and profitability. Thankfully, it really isn't all that complicated. Set aside all the jargon and what we're talking about is a fairly simple concept: Uniqueness – identifying what truly differentiates your company from all the other companies competing for the exact same dollar and, then, identifying the customers who are most willing to pay for those differences.

That's not to say that Strategic Planning isn't hard work. Thinking creatively about anything is hard work. But we're not talking about a herculean effort to create a 50-page plan that gets compiled once a year and, then, sits on the CEO's shelf until the next year's plan is created (we call those SPOTS – Strategic Plans on Top Shelves). What we're talking about is *thinking*, and the appropriate acronym is PIEPAN – Planning Is Everything, Plans Are Nothing. It's the ongoing strategic thought process that's important, not the SPOT. To paraphrase chess master Sun Tzu: "Your strategy lasts only until your opponent's next move". The point is that Strategic *thinking* needs to be an ongoing process, not an event that occurs just once a year.

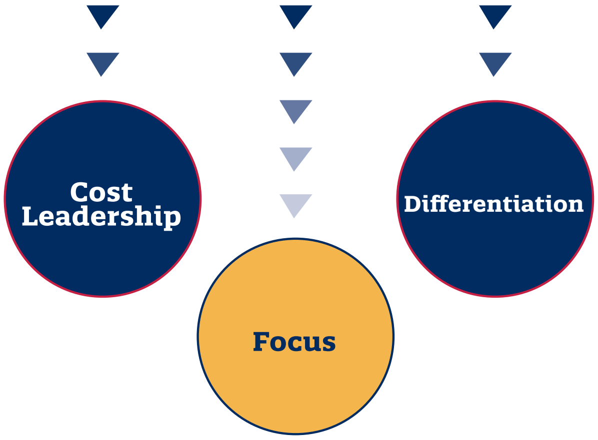
In the pages that follow, you'll find your Strategic focus by carefully examining the environment in which you compete and, then, determining your most profitable niche. Finally, you'll define a small handful of key priorities which will serve as the basis for your short- and longer-term goals.

As you work through the Strategy component, you should continuously remind yourself and your team that your goal is to determine **where to play** (target market) and **how to win** (competitive advantage) within the context of your **Core Purpose** and **Envisioned Future (BHAG®)**. In particular, you're looking for needs that aren't currently being met or that could be met in a different way than the "industry standard".

One final note: Killer strategy rarely happens over-night, and you're unlikely to nail yours on your first attempt (or, even, second or third attempts for that matter). But don't give up! Strategic planning is a very messy process that can take years to fully develop.

For a very good overview of the process, as well as references to several "must read" books on strategic planning, read Chapter 7 ("The Seven Strata of Strategy") of Vern Harnish's book *Scaling Up*.[14] We love Vern's approach; however, we've found it to be somewhat over-whelming for many of the clients we serve, so we've distilled the process to just a few core elements.

SITUATION ANALYSIS



Strategy is all about identifying a sustainable competitive advantage that will allow your business to consistently earn above-average profits. To develop such a strategy, you need to have a comprehensive understanding of your company's current position in the marketplace. This is a process of discovery that involves a lot of data gathering, a lot of analysis, and a lot of creative thinking.

As you work through the process, it's extremely important that you base your decisions on facts rather than unverified assumptions. "I heard that so-and-so is thinking about entering our market" should not be a strategic consideration until and unless it's been verified. That's not to say that gut feelings don't matter. Gut decisions can be very important (especially when creativity is involved), but only after all the fact-based data has been gathered and thoroughly analyzed.

And that's the purpose of doing a Situation Analysis: gather data, analyze it, and decide which factors are most important to your overall strategy. A comprehensive Situation Analysis consists of the following activities:

1. Industry Research
2. Financial Benchmarking
3. Competitor Profiling
4. SWOT Analysis

Industry Research. A good place to start the discovery process is to review current industry-related publications such as trade journals, association publications, and trade show materials. Look for key trends, new product announcements, M&A activity, and anything else that might signal a change in the competitive landscape. IBIS World is also an excellent source of market information. Their publications are expensive, but can be obtained at no-cost from your local SBDC consultant.

Financial Benchmarking. It's important to know your company's financial strengths and weaknesses relative to the competition. The ultimate goal, after all, is to earn higher-than-average profits relative to your industry. That's difficult to do if you're not growing faster than the industry, or if your balance sheet is weak relative to the competition. Ask your local SBDC consultant for a financial benchmarking report at the same time you ask for an IBIS World report.

Competitor Profiling. You also need a thorough understanding of your position within your industry relative to your competitors. A good place to start is with a Competitor Profile. First, by develop a list of key industry success factors. Then, rank those factors by importance ***to your customers*** (see the worksheet on the following page).

Industry Success Factors – Examples

Product Quality	Cost Leadership (Price)	Supply Chain (Sourcing)
Delivery Times	Ease of Access	Sustainability
Customer Service	Production Capacity	Features/Benefits
Social Media	Product Integration	Durability
Brand Reputation	Online Presence	Ongoing Support
Product Features	Customer Service	Country of Origin

Finally, rate your competitors relative to your company. The idea is to identify:

a) areas in which your company needs to improve (i.e., weaknesses relative to your competitors), and

b) areas that your company can potentially exploit (i.e., strengths relative to your competitors).

As you're working through the grid, make sure you're brutally honest with yourself about your company's relative standing. Note where your company is strongest and weakest and keep the Profile you developed nearby. You'll be referring to it as you prepare your SWOT analysis.

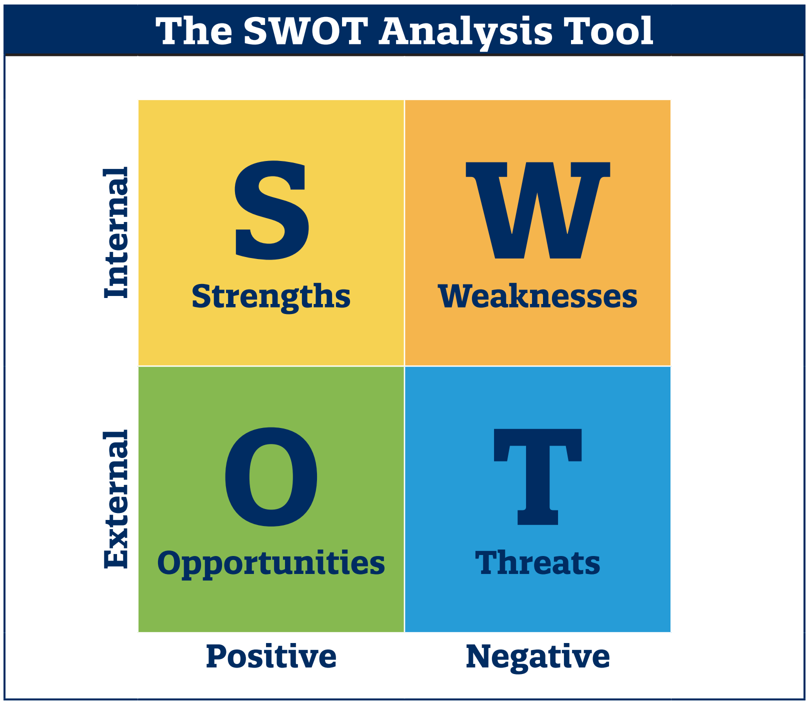
Competitor Profile

Key Success Factors	Your Company	Competitors
1.		
2.		
3.		
4.		
5.		
6.		
7.		
8.		
9.		
10.		

NOTE:

- Determine the key success factors within your industry (e.g., cost leadership) and rank them by importance to your customers.
- For each competitor and your company, use "S" to denote a relative strength and "W" to denote a relative weakness.
- Look for exploitable gaps (areas in which you are strong but your competitors are weak) as well as areas which need improvement (areas where you are weak but your competitors are relatively strong.

SWOT Analysis. A great way to organize and synthesize information that can help you hone your marketing strategy is to perform a SWOT analysis. SWOT stands for "Strengths, Weaknesses, Opportunities, and Threats" and is one of the oldest (and most useful) tools for developing strategy. As well as you may think you know your business, a SWOT analysis will force you to look at it in new ways and from different angles. The idea is to find ways to maximize your strengths and opportunities, while minimizing your weaknesses and the possible impact of the threats you face.



Strengths are internal, positive aspects of your company that are, generally, within your control. They are the inherent aspects of your organization that have been the source of your success. Strengths might include, for example, a key business process, intellectual capital, your brand, or long-term contracts that lock out competitors for the foreseeable future.

Weaknesses are internal, negative aspects of your company that detract from your strengths. Often, these are aspects that are unlikely to change (e.g., difficulty filling open positions). Sometimes, however, you'll identify a weakness that does need to change (e.g., poor morale). And on rare occasion, a weakness can actually be an opportunity. For example, if all your competitors are having difficulty filling open positions, and you can develop a novel way to attract and retain employees (*hint: Core Values*), you may have just given yourself a significant competitive advantage.

Opportunities are external factors and trends that potentially can be exploited in your favor. Rapid industry growth, technological advances or faltering competitors often represent significant opportunities. Also think about industry-wide pain-points: What's the one issue within your industry/target-market that everyone complains about, and what solution could your company offer?

Threats are external, negative factors and trends that may put your company at risk and that you can't control (but may be able to counter). Threats might include a new competitor entering the market, the impact of international trade scuffles, "uppity" suppliers, or the planned retirement of a key contact at a large customer.

To perform a great SWOT analysis, follow these guidelines:

1. As always, make sure you're working from facts, not assumptions. Again, be brutally honest.

2. Start by reviewing the Competitor Profile you created, and transfer any obvious strengths or weaknesses to the SWOT worksheet.

3. Then, brainstorm additional strengths and weaknesses. Evaluate every functional aspect of your business (e.g., Marketing/Lead Generation, Sales/Lead Conversion, Operations/Customer Fulfillment, Finance, HR). Also, think about everything you own, such as your physical property, intellectual property, brand equity, human capital and culture.

4. Next, brainstorm external factors, especially key trends, that could represent opportunities or threats. A good framework for thinking about external factors is PESTLE, which stands for Political, Economic, Socio-cultural, Technological, Legal and Environment. Wikipedia has an excellent description of the PESTLE framework, which can be found here. Look for common industry weaknesses that, with some creative thought, you could turn into opportunities.

5. At this point, you should have a robust list of SWOT items to consider. The next step is to prioritize the items in each of the five SWOT boxes by potential impact on your company and transfer the top 3 items in each box to a new SWOT worksheet.

6. Put a copy of your prioritized SWOT analysis in your Leadership Team Manual. You'll be revisiting it in the next section.

Get to Work

SWOT ANALYSIS

	Strengths	Weaknesses
Internal		
	Opportunities	**Threats**
External		
	Optimize	Mitigate

Notes

Market Position

Now that you've thoroughly analyzed your competitive situation, it's time to work on positioning your company to take advantage of its strengths and opportunities.

In this section, you're going to define your:

1. Core Product,
2. Ideal Customer,
3. Differentiators, and
4. Brand Promise.

Core Product. Your company's Core Product is, quite simply, what it strives to be the best at. Lexus, for example, strives to be the best "mid-cost" luxury automobile manufacturer on the planet. Orville Redenbacher, when it started out, strove to be the best at producing microwave popcorn. Until the mid-1980's, Starbucks strove to sell only the best gourmet coffee beans. The question is: What do you want your company to be the best at?

Don't overthink the question! The concept, while simple, serves a very important purpose: To help you remain focused on the "what" that is going to drive your company's success.

Once you've defined your company's Core Product ("Best At"), add it to your Company Compass®.

Target Market. Defining your target market is all about identifying and locating your ideal customers – the group of buyers who perceive the most value in your product offering (and are willing to pay for that value!). By identifying and targeting specific market segments, you'll be able to focus your limited resources on attracting the most profitable customers. This doesn't necessarily mean you're going to exclude segments that don't fit your core criteria. You're just not going to spend a lot of time or money marketing directly to them.

As Michael Porter, the father of modern strategy, famously noted: "The essence of strategy is choosing what NOT to do". In other words, everything becomes easier (and more effective) when your strategy is narrowly focused on a single market segment. Your people are aligned more clearly. You can present a brand story that is clearer, more succinct, and memorable. And the user experience can be laser-focused on meeting your customers' needs.

To identify your target market, a good place to start is with your best customers; the ones who are most profitable and you most enjoy working with. Ask yourself: what makes them different from your other customers? Why do they buy from your company (rather than the competition)? What problems are you solving for them (better than anyone else)? Ask them what they value most in your business. Gather as much geographic, demographic and psychographic information as you can. Where are they? Who are they? What are their wants, needs and fears? What motivates them to buy? Look for common themes.

Use this information, along with the market research you gathered earlier (including your SWOT analysis) to develop an Ideal Customer Profile (ICP). An ICP is a detailed description of the segment of the market that finds the most value in your product offering (see the worksheet that follows). Have each Leadership Team member fill out the ICP worksheet. Then, section-by-section, narrow everyone's lists to a single set of key characteristics. Once you've finalized your company's ICP, write a short paragraph describing your Ideal Customer and transfer it to your Company Compass®.

Ideal Customer Profile

Category	Characteristics
Demographics	
Geographics	
Decision-Making Factors	
Pain Points/Need (Problems You Solve)	
Business Objectives (B2B) OR Personal Desires (B2C)	
Other Notable Attributes	
List of Key Prospects (B2B Only)	

GETTING TACTICAL: WEEDING THEM OUT

Now that you know what your Ideal Customer looks like, take stock of how many of your current customers aren't ideal. Which ones aren't any fun to work with, are uber-demanding, don't pay you well (or on time), never make referrals, and/or make you cringe when you think about them. List them all, along with an estimate of their real contribution to your bottom line. By "real" we mean after accounting for the cost of all the unnecessary phone calls, personal visits and other demands that put these customers on your "crappy customer" list in the first place.

During the start-up stage, most business owners will take any customer they can find. It doesn't matter if the customer fits their core business model, or if the customer is going to demand twice as much service as a typical customer, or stretch their payments to 120 days, or is a pain-in-the-you-know-what to work with. All that matters is the score, the addition of a new customer, the confirmation that there is another customer out there who is willing to pay – however poorly – for their product offering.

The problem with this approach is that it distracts owners from being able to focus on 1) their best customers – the ones who pay well and on time, the ones who refer, the ones who make running a business fun in the first place, and 2) finding more ideal customers. In other words, the non-ideal customers most often represent a huge roadblock to sustainable growth and profitability.

According to Mike Michalowicz, author of – among others – The Pumpkin Plan, "There are three types of clients, and their importance is ranked exactly as follows: 1. good clients, 2. non-existent clients, and 3. Bad clients." He goes on to say "You need to shift your mindset away from the quantity game. You need to stop killing yourself for scraps. <<You need>> to kick your fears in the teeth and start focusing on the clients who, when you love them (and others just like them), will make your wildest revenue dreams possible[15]."

In other words, if you truly wish to take your business to the next level, you need to make plans to fire your worst customers, so that you can focus on your best customers (and finding more of them).

Differentiators. Your company's ability to grow faster than your competitors and earn higher-than-average profits is largely dependent upon its ability to exploit a competitive advantage. Your company's competitive advantage, in turn, is largely determined by its ability to differentiate itself. Differentiators are unique-to-your-company features and/or benefits *that your customers are willing to pay for*.

There are many possible sources of differentiation but, in general, differentiators fall into one of two categories: product-level and activity-level:

Product-level. Product features and benefits can be a good source of differentiation. The idea is to identify unique characteristics that make your product offering more valuable to your customers than your competitors' offerings. Product-level differentiation can include both design features (e.g., durability, ease of use) and benefits (e.g., performance, outcomes). Product level differentiators are, unfortunately, often easy for competitors to imitate. As such, constant innovation is usually required in order to maintain a product-level competitive edge.

Activity-level. Choosing to perform activities differently than the competition (or choosing to perform different activities altogether) is, perhaps, the best strategy for differentiation. The idea is to create a "signature" process for how your company will deliver its products or services. Many times, this "signature" process will form the basis for your brand. Netflix, for example, put Blockbuster out of business; first, by changing how movies were delivered to people's homes and, second, by offering a new subscription-based pricing model which eliminated the late fees (the one thing that everyone hated about Blockbuster).

FedEx, as another example, invented the tracking number and then completely upset the industry with its promise to deliver anything overnight.

Unlike product differentiators, activity-level differentiators are often very difficult to imitate (because they can take years to develop). And, for a differentiator to offer a *sustainable* competitive advantage, it must be (very) difficult to imitate.

The idea is to identify several key differentiators that aren't fully shared by any of your competitors. In other words, it's o.k. if a competitor shares a couple of them, but *no competitor should share all of them*. Otherwise, the only "advantage" you'll be able to offer your customers is price (and it's usually very difficult for small businesses to successfully pursue a low price/low cost strategy). The key to a *sustainable* competitive advantage is to identify differentiators that your competitors won't, or can't, imitate without great expense or effort.

Competitive Advantage:

"A company can outperform rivals only if it can establish a difference that it can preserve. It must deliver greater value to customers or create comparable value at lower cost, or both."

Michael Porter

You may have identified one or more differentiators when you performed your situation analysis. If, however, you've decided that either "Quality" or "Service" is one of your core differentiating activities, be forewarned: When we work through this exercise with our clients, more often than not they initially choose "Quality" or "Service" as a differentiator. And that's the problem: *most* companies believe that their quality or service (or both) is better than the competitions'. In other words, it's rare that "quality" and "service" are true differentiators. Your company *may* be different, of course, but don't choose either unless you can objectively and unambiguously demonstrate that your quality or service is measurably better than your competition (and, again, that your customers are willing to pay for that distinction).

If you're struggling to identify your key differentiators, ask yourself the following questions:

1. How can my company exploit the industry weaknesses that we identified when we worked through the situation analysis? Think about the one problem that everybody in the industry complains about, and then try to find a solution to it.

2. What does (or can) my company do that no-one else in the industry is doing? The answer to this question may lie in how other industries do business.

3. What are my Ideal Customers' pain points? What do they complain about most?

Once you've defined your key differentiators and made sure that at least one of them is truly unique (and valuable to your customers), transfer them to your Company Compass®.

Differentiators

	Competitors		
Product-Based (Features & Benefits)			
Activity-Based			

Use this template to identify product-based and activity-based differntiators that:

1. Make your product offering UNIQUE vs. your competitors, and
2. Make your product offering more VALUABLE to your customers.

Some competitors may share some of your key differentiators, but you need to find AT LEAST ONE that is truly unique to your company.

Brand Promise. At this point, you should have a very deep understanding of the environment in which you compete. You've identified your company's strengths and weaknesses (as well as opportunities and threats), its niche (Core Product + Ideal Customer), and several factors that make your company unique versus the competition. Now it's time to take all of that information and boil it down into a single "brand promise" statement which succinctly describes how you will consistently deliver your product or service.

Your Brand Promise isn't simply a tag-line or a marketing slogan. It's a simple statement about the essence of what really matters to your customers (and prospects), and why they should repeatedly choose your company's product over your competitors'. It's an ***internal*** rallying cry which captures the essence of what your customers can expect each-and-every time they interact with your company.

To be effective, a Brand Promise should meet several criteria:

1. It must be simple / memorable.
2. It must be credible.
3. It must address your ideal customer's most important need. Be careful to distinguish needs from wants: As Scaling Up's Verne Harnish notes, your customers will "want, want, want you all the way to bankruptcy if you let them!"[16]
4. It must demonstrate that your company can meet that need better than your competition (in other words, it should provide an extremely high level of differentiation/uniqueness).
5. It must fully align with your company's overall Vision (Core Purpose, Core Values and Envisioned Future).
6. It must be measurable – there must be an objective measure of whether your company is consistently meeting its Brand Promise.

McDonald's provides a good example. While their core product is food, their primary Brand Promise – which fundamentally boils down to convenience and consistency – has little to do with specific product features. It does, however, address their customers' most important needs: They're hungry now, and they don't want to be surprised by their meal. In addition, Mickey D's demonstrates their promise in virtually everything they do: Not only is their distribution system ubiquitous and easily recognized, they do everything they can to ensure that a Big Mac purchased in Kalamazoo, Michigan tastes and looks exactly the same as a Big Mac purchased in Glasgow, Scotland. Is it measurable? Absolutely! They know exactly how long their customers' wait-times are, and they fanatically control their supply chain and cooking process to ensure consistency.

Once you've identified your Brand Promise, add it to your Company Compass® and start tracking your ability to deliver on that Promise. Once you're reasonably comfident that you're able to deliver on your Promise close to 100% of the time *and* that your Promise is highly valued by your customers, you're going to want to consider turning that Promise into a *Guarantee*.

A Brand Promise Guarantee takes the Brand Promise one step further by penalizing your company for not delivering on your Promise. It is, perhaps, the single most effective way to overcome buying objections. In addition, it amplifies your company's focus on delivering an extremely high-level of service to your customers, and it takes the differentiating power of your Brand Promise to an entirely new level.

Some of our favorite examples of Brand Promise Guarantees include:

- ✓ First Hampton Inn's guarantee of "Friendly service, clean rooms and comfortable surroundings every time. If you are not satisfied, we don't expect you to pay."
- ✓ Sweetwater Music's 30-day, no-questions-asked, money-back guarantee that includes return shipping.
- ✓ Ben Franklin Plumbing's guarantee of "If there is any delay, it's you we pay." They'll pay the customer $5 for each minute they're late (up to $300).
- ✓ The short version of BBBK's guarantee which, essentially, says "If you're not 100% satisfied, we won't take your money." Actually, their guarantee goes well beyond a simple refund. Take a few minutes to read The Power of Unconditional Service Guarantees.

Deciding to turn your Promise into a Guarantee isn't something to be taken lightly. Once you go there, it's very difficult to undo. While the benefits can significantly outweigh the costs, you want to make sure your organization can consistently deliver on your promise before you pull the guarantee trigger.

GETTING TACTICAL: WORDS YOU OWN[17]

In Scaling Up, Vern Harnish notes that "87% of ALL customers (business, consumer, and government) search the Internet to find options for purchasing products and services." In other words, whether your business is B2B or B2C (or B2G), it needs to have a significant (and unique) internet presence to be competitive in today's cluttered digital marketplace. The key, as Harnish says, is to own "words that matter" so that you can dominate search engine results. Harnish goes on to give a few examples: Volvo owns "safety"; BMW owns "driving experience"; and Google owns "search engine". He notes that "If you want to hurt a competitor, steal its word, as Google did with Yahoo."

A great way to determine what words are owned by your competition is to search the internet for words or phrases you think prospects might search for when looking for products like yours. If your company isn't ranking very high in the search results, you need to take action.

A good place to start is with Google's AdWords Keyword Planner. This tool will show you how many times your target word or phrase has been searched, as well as the frequency with which related words are searched. It will also tell you how many advertisers are bidding for a particular term. Then, you can decide whether you want to try to outbid your competitors to own a particularly popular word or phrase, or if you want to "build-up" a slightly less used phrase.

You'll also want to update your Google business profile. Your Google My Business(TM) profile is what determines how you'll show up on Google Maps and in "Local Results" for Google searches.

At this point, it's time to start creating content that exploits the words you want to own. Blogs and, especially, videos play a crucial role in marketing strategy. Keep them short and sweet, but make sure they're useful and reference the words you want to own. And have patience. Building a strong network of "words you own" takes time.

Note: your SBDC consultant can provide you with a very informative SEO (Search Engine Optimization) analysis (at no cost, of course). This is a very detailed analysis which can help you identify the strengths and shortcomings of your web efforts.

Targets & Priorities

At this point, you know the *why* (your Vision), the *who* (your ideal customer) and the *what* (your differentiated offering). Now it's time to start thinking about the *when* and the *how*. In other words, what should the numbers look like for the next 1- and 3-years (the *when*), and what are the key assumptions that will drive those numbers (this is the start of the *how*).

Start by reviewing everything you've compiled up to this point: Your Company Compass, Competitor Profile, SWOT analysis, and ICP. Then, working with your Leadership Team, develop top-level financial targets for the next 1- and 3-years. As you're developing these targets, be sure to note all of the key assumptions that are driving the numbers (especially for the 1-year target). For example, if your targeted year-over-year sales growth is 20%, what assumptions are driving that sales growth? Is it dependent upon successfully rolling out a new product? Or hiring a new sales person? Or closing seven new clients? Or something else altogether? Other considerations might include:

1. Given what you know about the trends and opportunities within your target market, is it reasonable to assume that your company will grow faster than the industry as a whole? Are there opportunities for price increases? Will your gross margins remain constant, or could there be changes in the costs of inputs that would cause them to improve or deteriorate?

2. Given your best guestimates of sales growth, what changes in infrastructure will you need to support the growth? How many more employees will you need? Will you need to purchase or lease a new facility or new equipment and, if so, at what cost? Does the growth rely on some new initiative? Will you need to significantly increase your marketing and advertising efforts?

3. Are there any cost/efficiency-related initiatives that you could undertake that would significantly increase your company's profitability or competitive position? If so, what are they and what might they cost?

The result will be a summary that looks something like this:

Long-Term Plan

	LAST YEAR	**NEXT YEAR**	INC/(DEC)	3 YEARS OUT
SALES/REVENUE	$1,850,000	**$2,220,000**	$370,000	$2,935,950
GROSS PROFIT	$888,000	**$1,132,200**	$244,200	$1,497,335
GPM (%)	48.0%	**51.0%**	3.0%	51.0%
OPERATING PROFIT	$161,000	**$207,200**	$46,200	$287,335
OPM (%)	8.7%	**9.3%**	0.6%	9.8%
INVESTED CAPITAL	$1,341,667	**$1,541,667**	$200,000	$1,641,667
ROIC%	12.8%	**18.0%**	5.2%	21.0%

Critical Assumptions/Strategic Priorities

1 Year

- ✓ *Establish West-Coast Distribution Center by May 31st.*
- ✓ *Line 1 scrap rate is reduced by 50% no later than December 31.*
- ✓ *Hire Marketing Director by September 30.*
- ✓ *Roll-out "Cutlass" model by April 30.*

3 Year

- ✓ *Expand production capacity by 50%.*
- ✓ *Establish European Distribution Center.*
- ✓ *Document all Core Systems and Processes.*

You're probably familiar with every line-item on the summary except "Invested Capital" and "ROIC". Invested capital is the amount of money that's been invested in your business's productive assets – basically, the book value of your fixed assets and net working capital. ROIC stands for "Return on Invested Capital" and it's a relatively simple way to measure whether your plan creates value for your business. In other words, it answers the question: Is my business earning a return that justifies all the time, energy and capital that I'm investing in it? We'll get into the details of Invested Capital and ROIC in the Cash Flow component of Focus Four™.

Once you've settled upon reasonable top-level targets, it's time to get very granular: You're going to turn your 1-year plan into a detailed, monthly operating budget (and, yes, we can already hear you groaning). As painful as this exercise may sound, it's critical for several reasons. First, the monthly budget can serve as an excellent accountability tool. Essentially, every single line item on your P&L and Balance Sheet should be owned by someone within the organization. Second, your monthly budget will serve as the baseline for creating ongoing cash flow forecasts. This is a key skill that can help you identify problems before they become crises.

Generating detailed financial plans is an area that causes many small business owners a great deal of consternation. But it needn't: This is an area in which the SBDC excels. So, rather than providing a template for this section, if you don't have the capability to generate detailed financial forecasts, we highly recommend that you solicit your SBDC consultant's active participation. We have some of the best "number-tumblers" on the planet!

As you get into the details, you'll probably discover that some of your top-level targets are unrealistic or undesirable. That's perfectly normal. Planning is an iterative process, full of "what if's" and dead-ends. Ultimately, though, you'll settle on a "most-likely" scenario and, when you do, add it – and the most critical assumptions – to your Company Compass®.

Your Company Compass: Focus 2

STRATEGY

Core Product/Service

Brand Promise

Ideal Customer

Differentiators

Long-Term Plan

	LAST YEAR	NEXT YEAR	INC/(DEC)	3 YEARS OUT
SALES/ REVENUE				
GROSS PROFIT				
GPM (%)				
OPERATING PROFIT				
OPM (%)				
INVESTED CAPITAL				
ROIC%				

Critical Assumptions/Strategic Priorities

1 Year

3 Year

Focus 3 – Execution

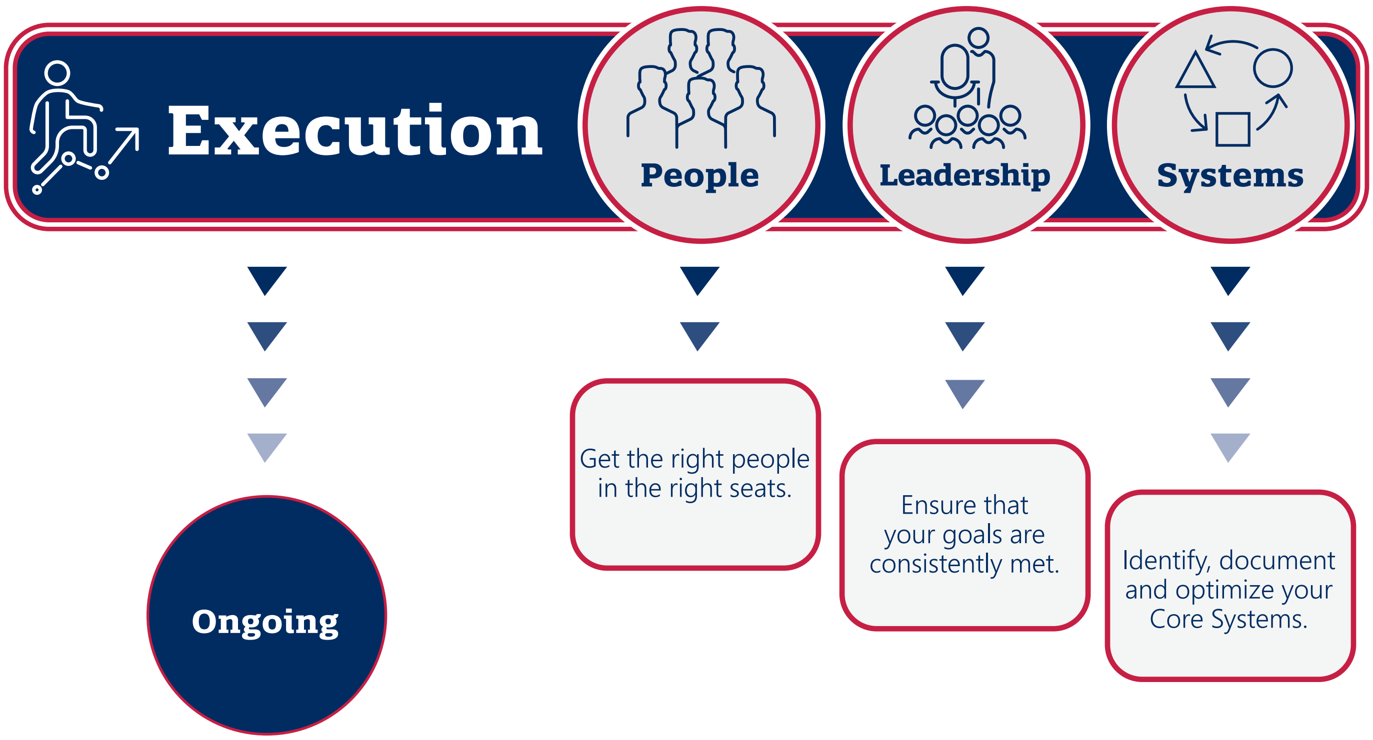
Focus 3 – Execution

> **"Leadership is the ability to translate Vision into Reality."**
> **Warren G. Bennis**

Until now, you've spent most of your time thinking, analyzing, and strategizing: *Where* do you want to take your business, *why* do you want to go there, and *how* do you plan to get there.

Now it's time for the *doing* – the goal-setting and *goal-getting*. This is the hard part: Execution is where most small businesses falter because it requires unrelenting discipline.

Why? Mostly because of what Sean Covey refers to as the "*Whirlwind*"[18]. The *Whirlwind* represents all of the urgent daily stuff that demands our attention, *regardless* of importance. It's the phone calls, the e-mails, the customer crises, the fire-fighting and, of course, the must-do, daily tasks that consume our 10-, 12- and 14-hour days. It's the beast that rarely lets us get to the *not*-urgent (but extremely important) strategic issues that will take our company to the next level. And, unfortunately, when urgency and importance clash, urgency wins every time![19]



The challenge, and the reason that discipline is so necessary, is to consistently execute in the face of the *Whirlwind*. The *Whirlwind* will never go away, and it *shouldn't* go away – much of the what it demands of us *is* important. The idea isn't to eliminate the *Whirlwind* entirely but, rather, to make strategic goal-setting and goal-getting an integral part of it. Doing so requires that you 1) have the right people in the right seats, 2) have a robust leadership process, and 3) have well-documented (and optimized) systems.

Note: If you've skipped straight to this section, be forewarned: Without a well thought out Vision and Strategy to guide your Execution, any traction that you gain is likely to be misguided. A company that builds roads may be extremely effective at cutting down trees and laying concrete but, without a compass, it could very well be building roads that lead nowhere.

Finally, there is a fifth key seat which we'll call the Chief Entrepreneurial Officer or "CEO". The CEO is the Dreamer, the Visionary. S/he drives the growth of the business: S/he sees opportunities, thinks strategically, creates things and is seemingly in a constant state of change. That constant state of change – the desire to create and chase opportunities – can, however, lead to a state of organizational chaos.

And this is where the COO's role becomes critical: The COO serves as the buffer between the CEO and the rest of the team. Where the CEO seeks change, the COO seeks order. Where the CEO creates new things (including, often, chaos), the COO creates processes to deliver those new things when it's appropriate to do so. This is a key point: For every 100 ideas the CEO dreams up, maybe one of them will be worth pursuing. And it's the COO's job to (tactfully) say "No!" to the 99 bad or poorly-timed ideas that will distract the organization from its core focus and/or create unnecessary organizational chaos.

As Michael Gerber, the author of the EMyth observes: The General Manager (COO) will build a house and live in it forever; the Entrepreneur (CEO) will build a house and immediately start planning to build the next one.[20]

But here's the thing: In small businesses, the COO and CEO seats often are occupied by the same person – the company's owner. And, while both seats are necessary, it's rare to find owners who can effectively balance both roles. To quote Michael Gerber again, "the typical small business owner is 10% Entrepreneur, 20% Manager and 70% Technician".[20] The challenge, then, is for small business owners to, first, learn to let go of being a "technician" (the hands-on doer of everything) and, then, to balance the competing roles of the COO and CEO seats.

The COO seat requires the ability to directly lead a team of people – through goal-setting, coordinating and delegating responsibilities, and holding people accountable. In other words, the COO seat is almost exclusively Execution-oriented. The CEO's seat, on the other hand, is focused almost solely on Vision and Strategy. The seat also requires the ability to lead, of course, but in a less direct way. The CEO leads by repeatedly and consistently communicating the company's Vision, ensuring its Values are lived and breathed throughout the organization, and inspiring the organization to continuously reach for bigger and better things.

In total, then, there are five core seats that should comprise the heart of your Leadership Team: The CEO, the COO, and the three key technical roles (Sales, Operations and Accounting). The titles aren't important, of course, but the roles are critical: your company will only be as strong as its weakest seat. For example, if you have a great customer fulfillment team (operations) but you can't sell, you'll quickly run out of cash. Similarly, if you have a great sales team but no real finance or accounting function, you're also likely to run out of cash (or, at least, leave a lot of cash on the table).

AGAIN, WHAT IS AN ENTREPRENEUR?

Ask a thousand people what the word "entrepreneur" means, and you're likely to get a thousand different answers. For the purposes of Focus Four™, we're defining entrepreneur as "someone who identifies profitable opportunities and develops systems and processes ***so that other people can do the work for them***." It's a visionary role as well as an enterprising role. Business owners are invariably enterprising, but as Michael Gerber pointed out in his classic book *The EMyth* (the 'E', by the way, stands for entrepreneur), most small business owners need to learn how to become entrepreneurs.

Responsibility Chart

C.E.O.
- Visionary/Dreamer
- Sees Opportunity
- Seeks Change
- Creates New Things (including chaos)
- Drives Growth

C.O.O.
- Pragmatist
- Sees Issues
- Seeks Order
- Creates Process
- Delegates, coordinates and holds accountable

Sales
- Lead Conversion
- Sales Growth
- Customer Retention
- Customer Journey

Operations
- Customer Fulfillment
- Quality Assurance
- Resource Control & Coordination

Accounting
- Bookkeeping
- Expense Control
- Administrative Support

Vision without execution is merely a dream. Execution without vision just passes the time. Vision with execution can change the world!

Joel Barker (paraphrased)

The Responsibility Chart demonstrates a typical organizational structure, along with some common roles and responsibilities for each seat. Use it as a guideline to creat your own Responsibility Chart. If your company is very small, it's likely that one person will occupy more than one seat (e.g., Sales and COO). If your company is larger, you'll probably want to add additional seats. But, again, no more than one person should occupy any individual seat. ***Seat-sharing kills accountability***.

Also, as you're creating your Responsibility Chart, don't think about the people who are currently in your organization. Think only about the roles and responsibilities that will be needed to take your company to the next level. In other words, think about what your Responsibility Chart should look like in the next 6 to 12 months rather than what it would (or does) look like given your current employees. We'll address finding the right people for those seats in a moment.

Once your Responsibility Chart is complete, ask each of your Team Leaders to create one for each of their areas of responsibility. Note: Studies have shown that the optimal team size is 8 people or less (one team leader and 7 direct reports). If you have teams with more than 8 – 10 people, you probably should re-think your organizational structure.

Finally, add the Responsibility Charts to your Leadership Team manual.

A LONG BUT IMPORTANT NOTE ABOUT ACCOUNTABILITY

While accountability is an important leadership tool, it shouldn't be relied upon as the sole – or even primary – means of task enforcement. A heavy reliance on leader-enforced accountability will not only distract the leader from more important tasks but will also – and most importantly – inhibit the trust and performance of those who s/he seeks to lead. High-performance team members don't need to be frequently "held to account" by their team leaders. They will hold themselves to account. They will enthusiastically do their job, and much, much more. And, they will be the first to raise their hands when they're having difficulty meeting their goals.

What makes for a high-performance team? Having the right people in the right seats who accept ownership for what they do and who fully understand and believe in "the why". Those of us who worked on the original draft of Focus Four™ are fortunate to be part of a high-performing team. Yes, we have goals – which we consistently exceed – but we're rarely "held to account" for our day-to-day tasks, and we frequently go above-and-beyond the expectations of our positions. Why? Because leadership has positioned us to take advantage of our strengths (right people, right seats). And because we buy into "the why" of what we do (help small businesses grow and prosper). And because we have the autonomy to own what we do – each and every one of us takes full responsibility for our actions.

Holding people to account – in the traditional sense of micro-managing a subordinate – does have its place, particularly when a team member is under-performing. But such micro-management should only be a temporary means to help the team member get back on track. If micro-management becomes a permanent part of the leadership process, then one of two things is occurring – either 1) the person being micro-managed doesn't "FIT", or 2) the person doing the micro-managing isn't leading.

How do you know if your team is being micro-managed? According to Jocko Willink, the author of Extreme Ownership and The Dichotomy of Leadership (which is, perhaps, our favorite book on leadership), there are 7 common symptoms of micro-management[21]:

1. The team shows a lack of initiative and will not take action unless directed.
2. The team does not seek solutions to problems; instead they wait for instructions.
3. Even in an emergency, the team will not mobilize and take action.
4. Bold and aggressive action is rare.
5. Creativity grinds to a halt.
6. Team members tend to stay inside their own silos (for fear of over-stepping their bounds).
7. There's an overall sense of passivity and failure to react.

Right People. The right people for your company are, ideally, the ones who 1) emphatically share your Core Values, 2) have the aptitude to do their job well (as defined by the seats on your Responsibility Chart), and 3) if they own a seat on your Leadership Team, are better than you'll ever be at their respective functions. They are people who you enjoy being around because they thrive in your culture, believe in your purpose and excel at what they do.

Getting the right people in the right seats can take time. But don't rush the process. It's better to go with an empty seat than to fill it with someone who doesn't fit with the rest of your team. On the other hand, you should get the wrong people – those who are toxic to your organization and its culture – off the bus as quickly as possible; even if it means that a critical seat goes temporarily unfilled.

In addition to sharing your Core Values, the right people will also share three additional characteristics. We call this the "**FIT Test**", and it's comprised of three questions:

1. Can they **Fulfill** the demands of the position, both now and in the future? Do they have both the physical (time) and mental capacity to get the job done? This is an especially important question if one person – like the owner – is trying to fill more than one seat.

2. Can they **Integrate** themselves into the team? Do they understand the importance of the position to the company as a whole? Do they understand how their role should interact with the rest of the organization?

3. Can they **Thrive** in the position? Is it a role that they look forward to performing? Are they energized and fully engaged by their duties?

Sticking to the "right people" mantra can be difficult. And it won't happen overnight. The idea isn't to immediately fire everyone who doesn't FIT (although truly toxic people should go asap). The idea is to slowly but surely encourage the wrong people to get off the bus and to replace them with the right people (often, people who don't FIT will self-select out of the organization as they see the rest of the company living by values they can't relate to). So, from this point forward, your Core Values combined with the FIT test should form the basis for all your people-based decisions.

Getting the wrong people off the bus can be especially difficult when friends and/or family are the ones who need to go. Often, they no longer FIT because the business has outgrown them. They may share your core values, but they can no longer fulfill the demands of the position. When this happens, you need to make a choice: you can carry them or you can let them go. If you decide to carry them, the business will likely suffer because a) others will have to take time away from their primary jobs to make up for the person's lack of skills, and/or b) something significant will fall through the cracks, often repeatedly (we see this *a lot* with the accounting seat). If you decide to let them go, the relationship is likely to suffer – at least initially. As time passes, however, the person who was let go will usually experience a huge sense of relief as they realize that they were, indeed, a poor FIT.

You probably already have a very good idea about who the right and wrong people are, but the "FIT Matrix" worksheet that follows can help you organize your thoughts. Rate each individual based on your Core Values and the FIT test: "+" (consistently demonstrates the value), "+/-" (sometimes demonstrates the value) or "-" (rarely demonstrates the value). *Any* minuses should raise a red flag: It is *extremely* difficult to change someone's values.

FIT Matrix

NAME	Core Value 1	Core Value 2	Core Value 3	Core Value 4	Core Value 5	F (Fulfill)	I (Integrate)	T (Thrive)
	+/-	+/-	+/-	+/-	+/-	+/-	+/-	+/-
	+/-	+/-	+/-	+/-	+/-	+/-	+/-	+/-
	+/-	+/-	+/-	+/-	+/-	+/-	+/-	+/-
	+/-	+/-	+/-	+/-	+/-	+/-	+/-	+/-
	+/-	+/-	+/-	+/-	+/-	+/-	+/-	+/-
	+/-	+/-	+/-	+/-	+/-	+/-	+/-	+/-

LEADERSHIP

One of the great perks of working for the SBDC is getting to know dozens-upon-dozens of talented small business owners. They are invariably bright, creative *doers* who are passionate about making a difference with their product offering.

> **"There are leaders and there are those who lead. Leaders hold a position of power or influence. Those who lead inspire us. We follow those who lead not because we have to, but because we want to. We follow those who lead not for them, but for ourselves."**
>
> **Simon Sinek**
> **Start with Why**

Unfortunately, only a relative handful of them successfully make the transition to a true growth mindset – from *doing* to *delegating*; from working *in* the business to working *on* the business. Some fail to do so because they don't want to – they're perfectly content running a "lifestyle" business. Others believe they've made the transition, but really haven't. They've built a "Leadership Team" but effectively run the organization as a benevolent dictatorship, making all the key operational decisions and sending their team "leaders" off to do their bidding. This micro-managed "hub-and-spoke" structure, with the owner at the center of everything, can work – but only up to a point. Sooner or later, the organization outgrows the owner's ability to manage every aspect of the business. There are, after all, only 24 hours in a day. Even workaholics can't get beyond that barrier.

What's worse, however, is that the organization never learns to get by without the owner's constant presence. So, in addition to hitting an inevitable performance ceiling, the company's valuation suffers. For two reasons: First, since the company is largely dependent upon the owner, when the time comes to transition the business (and that time *will* come), it can be extremely difficult to find a new owner who possesses all of the skills that are required to be an effective hub. Second, a primary variable impacting business value is growth potential, and hub-and-spoke structures are naturally limited in their ability to grow.

Why is value so important? Again, there are two reasons: First and foremost, if you make the majority of your business decisions within the context of increasing the company's value, you will invariably make the *right* business decisions. Second, at some point in time you're going to want to transition your business and, when you do, you're going to want to get the highest possible value for it. And a company that is largely dependent upon its owner is usually far less valuable than one that isn't. We'll dive into some of the details of "Value-Based Management" when we cover the Cash Flow component of Focus Four™.

Valuation issues aside, it's been our experience that owners of the most successful, and fastest-growing, small businesses have learned to get beyond their need to directly control every aspect of their business. They've learned to trust their team and to delegate (*not* abdicate!) most day-to-day activities to them. They've set up processes so that their business can run without their constant involvement. They've moved from the hub-and-spoke model, from being the "Easy Button"[22] for a team that truly hasn't learned how to make decisions on its own, to a true Leadership Team model – a leadership *process* – where functional leaders are both responsible for key decisions, and accountable for the results of those decisions.

To quote "*Dichotomy*" one last time[23]:

> "No one leader can manage it all or make every decision. Instead, leadership must be decentralized, with leaders at every level impowered to make decisions, right down to the front line troopers in charge of no-one but themselves and their small piece of the mission."

Before we get into the specifics of the leadership process, it's important to note that the effectiveness of the process depends, in large measure, on the effectiveness of the team that's being led. That's not to say that the process won't produce good results without a highly functional team; just that the results aren't likely to be as great as they otherwise might be.

Beyond having the right people in the right seats who aren't being micro-managed, a highly functional team is one where all members, *including the leader*, are confidently humble, forthright, quick to admit and learn from their mistakes, and willing to consider and respectfully debate differences of opinion. To quote from Patrick Lencioni's must-read book, *The Five Dysfunctions of a Team*:[24]

> "Great teams do not hold back with one another. They are unafraid to air their dirty laundry. They admit their mistakes, their weaknesses, and their concerns without fear of reprisal."

In other words, as Lencioni explains, the foundation for a great ("Cohesive") team is Trust. In the absence of **Trust**, team members are less likely to let their guards down, allow themselves to be vulnerable and speak their minds freely and openly. This results in fear of **Conflict**, which means you won't hear everyone's perspective, get great debate or get to the root cause of many issues. You're also likely to get a lot of back-channel sniping.

The ***Five Dysfunctions of a Team***
by Patrick Lencioni

The result of not debating different perspectives is usually a lack of **Commitment**, because team members won't feel like they've been part of the decision. And, without buy-in, there'll be an avoidance of **Accountability** and, ultimately, less-than-ideal **Results**. When team members are not holding one another accountable, they increase the likelihood that individual ego and recognition will become more important than collective team results. When this occurs, the business can suffer and the team often unravels.[25]

And, finally: Great teams have great leaders. More often than not, the best performing small businesses that we work with have owners who share many of the characteristics of what Jim Collins calls a "Level 5" leader[26]:

> "Level 5 leaders display a powerful mixture of personal humility and indomitable will. They're incredibly ambitious, ***but their ambition is first and foremost for the cause***, for the organization and its purpose, not themselves. While Level 5 leaders can come in many personality packages, they are often self-effacing, quiet, reserved, and even shy. Every good-to-great transition in our research began with a Level 5 leader who motivated the enterprise more with inspired standards than inspiring personality."

Of course, all of these concepts represent *ideals*. They are not absolutes: The leadership process that follows will work – to one degree or another – for almost any team and almost any leadership style. But there is great power in humility, vulnerability, and mutual respect.

Scorecard.

Since what gets measured gets managed, the starting point for an effective leadership process is to develop a Scorecard that demonstrates, at a glance, how the company is performing in several critical areas. By tracking a handful of Key Performance Indicators (KPIs), Scorecarding allows you to monitor the most important day-to-day activities that are central to operational success.

Using KPIs throughout your organization has numerous advantages: Accountability will skyrocket, individuals and teams will become more focused, and alignment of everyone's day-to-day work with the company's overall strategy will increase. In addition, since KPIs help clarify both authority and expectations, they will enable you to more easily delegate key tasks throughout the organization.

The primary drawback of Scorecarding is that developing useful KPIs isn't always easy, and the trial-and-error nature of getting them right can be frustrating, as can putting processes in place to track them. Do not, however, be deterred! Once you discover the right KPIs for your organization, you will wonder how you managed to get by without them: Ultimately, they *will* save you time and improve your, and your team's, ability to effectively manage the business.

Company scorecard – 1st Quarter

			Week Ending XX/XX/20XX				
Area	**Objective**	**Owner**	**KPI**	**Target**	**Actual**	**Trend**	**Notes**
Financial Performance	1. 10% YOY Sales Growth:						
	Increase Sales Effort	Dale	# of Sales Calls	10	11		
	Increase Prices	Brooks	Average Billing Rate	$225	$240		
	2. Minimum Cash Balance of $10,000:		Cash Balance	$10,000	$9.500		This is a lagging indicator.
	Improve A/R Days	Julie	A/R Days	30	40		
	Improve A/P Days	Julie	A/P Days	30	33		
Customer Satisfaction	1. Increase NPS to an average of 4.5	Dale	Thank you note to all purchasers	100%	100%		
Process Efficiency	1. Increase GPM by 1 point.	Jose	Reduce Cycle Time	4.5	4.5		
Organizational Health	1. Cyber Security Training	Kathy	100% Participation	100%	20%		Training program just rolled out this week

There are two types of KPIs – Leading and Lagging. Leading indicators can be directly influenced (managed) to obtain a desired outcome. In other words, they're a *predictive* measurement. Lagging indicators show the results of your team's efforts but, since they measure past performance, they cannot be directly influenced. Leading and Lagging indicators work in tandem. Think of them in terms of a simple formula:

Actions (leading indicators) => Results (lagging indicators).

A good example of a lagging indicator is the first line on your most recent Profit and Loss statement: Sales (or Revenue). That line item is cast in stone and cannot be changed. Next quarter's sales, however, *can* be influenced. The key is to identify one or more leading indicators that are both actionable (manageable) and directly influence the desired result(s).

The best way to develop leading indicators is to start with the desired goal or result (lagging indicator), and trace backwards to identify the activities that will influence the goal. For example, your sales process might consist of the following activities:

- Generating Leads
- Scheduling Appointments
- Closing the Sale

You might discover that for every 10 leads you generate, you're able to schedule 5 appointments. And for every 5 appointments you generate, you're able to close one new customer. In this case, a good leading indicator might be the number of leads generated each week since it's a measure that 1) can be directly managed, and 2) is predictive of the lagging indicator (sales). On the other hand, if leads are especially difficult to come by, you might want to focus on increasing your scheduling conversion rate from 5 appointments per 10 leads to 6 appointments per 10 leads. Or, you might want to work on the number of closes per appointment. The idea is to find the activity (leading indicator) which has the greatest impact on the desired result (lagging indicator). Often, this is simply a matter of trial-and-error.

The choice of which KPIs to use depends upon the nature of the activities that you consider to be most important to your company's operational success. Many businesses use a balanced approach, choosing a small handful of KPIs for each of four categories:

- Financial Performance
- Customer Satisfaction
- Process Efficiency
- Organizational Health

Others use KPI's that are aligned with each seat on their Leadership Team. There is no right or wrong answer, and either grouping is likely to result in a reasonably similar set of KPI's.

The key idea is to identify a group of KPIs that will allow you to guide the business from afar (say, for example, if you were to take a month-long vacation). For example, McDonalds is often referred to as the world's biggest small business. It has tens-of-thousands of independently owned-and-operated franchises around the globe, all of which are guided from a single office in Chicago, IL. They accomplish this feat by using a "balanced" scorecard to monitor their franchisees' KPIs on a regular basis. Only when a KPI is "off-track" do they need to take the time to check-in to see if there's an issue that needs to be resolved.

The core process for "getting stuff done" is, perhaps, best summarized in The 4 Disciplines of Execution:

1. Focus on the (Wildly) Important,
2. Act on the Lead Measure (KPI),
3. Keep a Compelling Scorecard, and
4. Create a Cadence of Accountability.

To identify your KPIs, hold a brainstorming session with your leadership team: have everyone list what they think are the most important variables to track, throw them all up on a white board, and whittle down the list until you have two or three KPIs for each of the 4 categories noted above (or, alternatively, for each functional area). If you're struggling for ideas, visit https://kpilibrary.com. Be very mindful of the effort that would be required to obtain the requisite data for each KPI. Initially, you want to make this process as easy to maintain as possible.

Once you've identified your KPIs, transfer them to your Scorecard and make sure you document exactly how each is calculated as well as the source of the data that's used for each calculation. Since people will be held accountable for hitting their KPIs, there must be zero ambiguity in their calculation. Also, try to include at least one KPI that measures how well you're delivering on your Brand Promise.

During the first month or two, you'll probably change several of your KPIs – you'll find that some aren't as predictive as you had hoped, and others are too difficult to obtain on a regular basis. But, ultimately, you'll settle on a core group of KPIs that will help you quickly "status-check" your business and identify trouble-spots before they become significant issues.

Beyond having meaningful and actionable KPIs, the keys to a great Scorecard include:

1. It's monitored at least weekly,
2. It specifies an objective goal for each KPI,
3. It specifies who's accountable for attaining the goal, and
4. It's easy to read – you should be able to tell at a glance which KPIs are "on track" and which KPIs are "off track". In our experience, the easiest way to accomplish this is to color code each week's entry: green is "on track" and red is "off track". (The Focus Four™ Field Kit contains a fully functional Scorecard).

Rocks.

While your Scorecard tracks the core of your day-to-day operations, Rocks are the high-priority ("do or die/ wildly important") 90-day goals that are tied directly to your strategic priorities. They may be as simple as "Increase quarter-over-quarter sales by 10%", or as complex as "Decrease the cycle time of Line 1 from an average of 10 minutes to an average of 8 minutes." Regardless, they denote quarterly goals that are critically important to attaining your company's annual targets and priorities (Note: If you're unfamiliar with the use of the term Rocks for wildly important goals, this article provides a bit of history).

To develop your company's rocks, start by reviewing your Company Compass® with your Leadership Team. Then, ask each member to list the most important things that need to get done within the next 90 days to ensure that the company's annual plan is accomplished. Put them all on the whiteboard. Eliminate redundant items (Use, Fuse or Lose"). Circle items that aren't directly related to the company's annual goals, but that could be good departmental goals. Prioritize the remaining items and choose the top two or three for your company's quarterly rocks.

The first time you do this exercise, you're probably going to end up with a very long list of "do-or-die" rocks, and you're probably going to want to commit to all of them. Doing so, however, would be a mistake: the more rocks you commit to, the fewer you are likely to accomplish. The old adage "if everything's important, nothing's important" is especially apropos to rock-setting. Focus solely on the top two or three priorities, and your odds of getting them all done will skyrocket.

Once you've determined your company rocks, ask each member of your Leadership Team to develop 2 or 3 departmental/functional rocks that support the company rocks (look to the circled items on the whiteboard first) or that are otherwise "wildly important" for their departments. If they have more than 3, ask them to prioritize them. Finally, have each team member read his or her top 2 or 3 rocks to the rest of the team. You want 100% buy-in from the entire team on both the company rocks and the individual departmental rocks.

The keys to developing effective rocks include:

1. As previously stated, don't over-commit. *No more than 2 - 3 per quarter* for the company as a whole, at least not until you have a couple of quarters with a 100% completion rate under your belt. Remember: company rocks will cascade throughout the entire organization: Depending on the size of your business, a single company rock could result in a dozen or more departmental rocks.

2. Make sure each rock is "SMART plus One" – **S**pecific, **M**easurable, **A**ttainable, **R**elevant, and **T**ime-bound plus owned by the ***one*** person who will be held accountable for its attainment. Try to state your rocks in this context: "From X to Y <<by when>>". For example:

   a. Company rock: Increase quarterly sales from $500,000 to $550,000 by the end of next quarter.

   b. Departmental rock: Increase new business closes from 10 per quarter to 12 per quarter.

   c. Weekly Commitment: Re-write our closing script to include responses for the most common objections by the end of next week.

3. Company rocks are often lagging indicators. In other words, they usually represent the *what* rather than the *how* (actions necessary to accomplish the rock). Department rocks are often leading indicators – they reflect the actions that must occur in order to realize the company rocks.

Once you've finalized your list, transfer your company and departmental rocks to the Goal Tracker.

Goal Tracker

Rocks - Q1			WeComs	
WHO	**ROCK (from X to Y)**	**STATUS**	**WHO**	**WHAT**
Company	1.	On Track		
	2.	Off Track		
	3.	On Track		
Sales	1.	On Track		
	2.	Off Track		
	3.	On Track		
Operations	1.	On Track		
	2.	Off Track		
	3.	On Track		
Finance/ Accounting	1.	On Track		
	2.	Off Track		
	3.	On Track		

"3D" List

Get to Work

Weekly Commitments. Weekly Commitments ("WeComs") are individual weekly activity commitments related to achieving Company or Departmental rocks. For example, the Sales Department might have a quarterly rock of "Increasing sales by 10%". Each week, every member of the sales department will commit to a specific activity that will help ensure that the quarterly rock will be attained. Weekly commitments help to ensure that quarterly rocks remain "top of mind" throughout the organization. We'll discuss the concept of Weekly Commitments more in the next section.

Meetings.

Ah, the dreaded "M" word. If you were to ask 1,000 people what they thought about company meetings, you'd probably hear comments like "I've wasted half my life in them" or "Yay! Donuts!". That's because most meetings are so poorly run that they are a waste of time. Yet, well-run meetings are as critical to the Execution component as are Rocks and KPIs. In fact, most small businesses need *more* meetings, not less, because meetings are also the heart-and-soul of the leadership process.

> **"In the 19 years I have worked with growing companies, the predictable winners are those who have established a rhythm and a routine of having meetings."**
>
> **Vern Harnish, Mastering the Rockefeller Habits**

To execute effectively, you'll need several types of meetings: Weeklies, Monthlies, Quarterlies and Annuals. Whether you call it a pulse, a rhythm, a beat or a cadence, you'll want to develop a routine of regularly scheduled meetings. This is, so to speak, where the rubber meets the road. This is where you ensure that the company remains focused, aligned and accountable. This is where you *lead*.

The Weekly Meeting (30-60 minutes).

The purpose of the weekly meeting is simple: to keep you and your team on track to meet your Scorecard- and Rock-related commitments. You'll use the time *exclusively* to tackle any issues that are putting your goals at risk, so that everyone's to-do list becomes a to-done list.

The weekly meeting is a *mandatory* meeting that should be held on the same day, at the same time and in the same place every single week. It's one of the few opportunities that you and your team will have to escape the daily *Whirlwind* and work, *as a team*, on the truly important issues that your company faces. It's also the best way to ensure that strategic goal-getting becomes part of the *Whirlwind*. By holding team members accountable for moving the ball forward each-and-every week, the goal-getting process will become habitual.

We'll cover the specifics of the weekly meeting agenda at the end of this section.

The Monthly Meeting (60-90 minutes).

The monthly meeting is a financial review meeting. The meeting should focus on where you've been (your prior month and year-to-date actuals), where you thought you'd be (your budget) and where you're going (your forecast). We'll get deeper into the details of budgeting and forecasting in the Cash Flow component but, conceptually, the financial format for the Monthly should be a variance analysis similar to the following:

Clinical Therapy, LLC

Variance Analysis

	January 31, 2020 (Month Only)			Year-to-Date January 31, 2020			Full Year 2020		
	Actual	Budget	Var	Actual	Budget	Var	Forecast	Budget	Var
Revenue:									
Collections	$215,884	$205,873	$10,011	$215,884	$205,873	$10,011	$2,975,995	$3,070,000	$(94,004)
Other	5,915	3,572	2,343	5,915	3,572	2,343	37,443	35,100	2,343
Refunds	(924)	-	(924)	(924)	-	(924)	(924)	-	(924)
Total Revenue	$220,875	$209,445	$11,430	$220,875	$209,445	$11,430	$3,012,514	$3,105,099	$(92,585)
Expenses									
Clinical Staff	63,999	73,475	9,477	63,999	73,475	9,477	1,033,763	1,043,240	9,477
Support Staff	50,933	50,777	(156)	50,933	50,777	(156)	755,632	755,476	(156)
Occupancy	10,207	19,423	9,217	10,207	19,423	9,217	228,680	237,897	9,217
Sales & Marketing	47,518	46,860	(658)	47,518	46,860	(658)	434,262	433,604	(658)
Other Admin	7,881	6,410	(1,471)	7,881	6,410	(1,471)	84,804	83,333	(1,471)
Total Expenses	$180,537	$196,946	$16,408	$180,537	$196,946	$16,408	$2,537,142	$2,553,551	$16,408
Operating Income	$40,338	$12,499	$27,839	$40,338	$12,499	$27,839	$475,372	$551,549	$(76,177)
Other (Inc)/Exp									
Interest Expense	249	665	416	249	665	416	7,563	7,979	416
Misc Other (net)	(475)	(553)	(78)	(475)	(553)	(78)	(8,655)	(754)	(78)
Total Other	(226)	112	338	(226)	112	338	(1,092)	(754)	338
Net Income	$40,564	$12,387	$28,177	$40,564	$12,387	$28,177	$476,464	$552,303	$(75,838)

The Quarterly Meeting (6 – 8 hours).

The quarterly meetings are ideally all-day affairs that serve a couple of very important purposes. First, they serve as an opportunity to refocus the team on your Vision and strategic priorities: to confirm that you're headed in the right direction and to make sure everyone continues to enthusiastically row in that direction. Second, they allow you to celebrate wins, measure progress, and re-set your company's rocks for the next quarter.

In his book *Traction*, Gino Wickman notes that, when things are running smoothly, there will be a strong temptation to skip a quarterly meeting (or two, or three). But doing so would be a serious mistake:

> *"If you don't continue to align quarterly, your organization will fragment to the point that you will get far off track, you will start to lose your great people, you <and your team> will lose sight of your vision, and you will end up right back where you started – in chaos."* [27]

Ideally, your quarterly meetings will address the following agenda items:

1. **Financial Review.** Review your Financial Performance for the quarter just ended compared to your targets. Celebrate wins and deconstruct misses: What can be learned as the team looks forward to the next quarter?

2. **Rock Review.** What percentage of last quarter's rocks did the team complete? If you didn't complete 100% of them, what went wrong? Again, what can be learned to increase the percent complete for next quarter's rocks? Did you simply over-commit, or is there a serious team (accountability) issue that needs to be addressed?

3. **SWOT Review.** Has anything changed in the competitive landscape that could significantly impact this year's results? If so, how does that impact the company's overall strategy?

4. **Company Compass® Review.** Review your company's Vision, its Strategy and its Targets. Make sure everyone is in 100% agreement. Also, review any Parking Lot issues to see if they need to be addressed during the upcoming quarter.

5. **Rock-setting.** Finally, you'll want to set Company and Leadership Team rocks for the next quarter. Look, first, to your "Parking Lot" and any rocks that weren't completed in the prior quarter. Again, if you didn't complete at least 80% of the prior quarter's rocks, or if your weekly meetings have been overwhelmed by rock-related issues, you might want to scale back your ambitions.

The Annual (1 – 2 days).

The annual meeting is similar to, and replaces one of, the quarterly meetings. It can last one or two days. The primary difference vs. a Quarterly is that you'll also be developing targets (including your budget) and critical assumptions for the upcoming year. If it's a one-day affair, the agenda will be identical to the quarterly meeting agenda, with the addition of some time spent developing financial targets and priorities for the upcoming year. If you decide to hold a two-day meeting, dedicate more time to the SWOT analysis and the budget-building process. Also, add the Weekly Meeting agenda (shown in the next section) to Day 2. Finally, use any additional time for some team-building activities.

The scope of the weekly, monthly, quarterly and annual meetings can seem a bit overwhelming at first. But if you and your team remain focused on the recommended agendas, you will quickly discover that they are among your most powerful tools for moving your business forward. In fact, depending on how quickly you're growing, or the severity of the crisis you're facing, you might also want to add a 5 – 10 minute "daily huddle" to the routine. Many rapidly-growing companies swear by them. And, don't forget, your SBDC consultant can help facilitate all aspects of your meeting routine.

The Weekly Meeting Agenda. As previously noted, the purpose of the weekly meeting is simple: to keep you and your team on track to meet your Scorecard- and Rock-related commitments. You'll use the time *exclusively* to tackle any issues that are putting your goals at risk, so that everyone's to-do list becomes a to-done list.

For the Weekly Meetings to be effective, it's important to adhere to the following agenda:

1. **Segue:** Give your team 5 minutes to settle-in, chit-chat, and "catch up". Share some good news. Appoint a Scribe and a Facilitator (see below).

2. **Scorecard Review:** Take 5 minutes to update the Scorecard. Capture any items that are in the red (off-track) on the "3D" List at the bottom of the Goal Tracker (we'll discuss the "3D" process - which stands for "Discuss, Decide and Do" - momentarily). *Don't discuss any possible solutions at this point.*

3. **Rock Review:** Take 5 minutes to update Company and Departmental Rocks ("On Track / Off Track"). Capture any items that are in the red on the "3D" List. Again, don't discuss any possible solutions at this point.

4. **Weekly Commitment Review:** Take 5 minutes to review the list of Weekly Commitments ("WeComs"). Capture any items that weren't completed on the "3D" List. And, once again, don't discuss any possible solutions at this point.

5. **Other Issues:** Take 5 minutes to identify any other *significant* customer-, employee-or competitor-related issues *that need to be addressed by the Leadership Team*, and add them to the "3D" List (again, without any solution-related discussion). Don't allow "day-to-day" issues that don't need the attention of the entire Leadership Team to sneak in.

6. **Prioritize:** At this point, your "3D" List will be comprised of off-track items from your Scorecard and Goal Tracker, *as well as any unresolved issues from the prior week*. First, review the List for any items that can be *quickly* resolved. Fix them and record any related WeComs. Then, take a few minutes to identify and prioritize the remaining items.

7. **Resolve:** Working from most to least important, develop solutions for each issue on the "3D" List. As previously noted, "3D" stands for "***Discuss, Decide, and Do!***" and the process is as follows:

> **"If you define the problem correctly, you almost always have the solution."**
> **– Steve Jobs**

The **Discuss** phase is about identifying the root cause of the issue. Teams we've worked with have had great results using the "5 Whys" approach: ask why the problem exists; when you get an answer, ask "why" again; repeat up to five times until you're certain that you've identified the root cause.

During this phase, two things are critically important: 1) ensure that everyone at the table voices an opinion, and 2) don't allow the strongest personalities to "politic" (i.e, forcefully and repeatedly re-state their position). Often, consensus will form quickly. Sometimes, however, the differences of opinion will be significant. And that's perfectly fine. Let the debate happen and either facilitate it to a resolution, or serve as the "tie-breaker" if it becomes clear there will be no consensus on the issue.

During the **Decide** phase, it's critically important to push for a solution. Just *Decide*. If you occasionally make a bad decision, that's o.k. Fix it and move on. But get in the habit of pushing for solutions. Sometimes the team will decide that additional data is needed before a reasonable solution can be identified. But 90% of the time, you should be making decisions in "real time".

The solutions will usually result in one or more Weekly Commitments. This is the **Do** phase, and it's important to capture these commitments on the WeCom tracker.

Repeat the 3D process issue-by-issue until you run out of time. If you believe that one or more of the remaining issues must be addressed by the Leadership Team before the next Weekly, schedule another meeting. Don't hold people hostage and extend the current meeting. Note: As you're working through your list of issues to be resolved, you might identify items that don't need to be addressed in the current quarter. Put those items on a "Parking Lot" to be reviewed at the next Quarterly.

Important: If you find that you're not consistently resolving all of the issues on your list, you probably have too many rocks. Keep that in mind the next time you develop your quarterly goals.

8. **Follow-Ups:** Create one or more WeComs to make sure you follow up with anyone outside of the meeting who might be impacted by decisions that were made in the meeting.

The weekly meeting will require two specific roles: a facilitator and a scribe. You can rotate the roles among the team members, or you can make permanent assignments.

Scribe. The scribe's role is to update the Scorecard and Rock Sheet, maintain the Weekly Commitment list, and keep track of any Follow-Ups.

Facilitator. The facilitator's role is to keep the meeting on-time, on-track, and focused on resolving issues. Team members, especially creative team members, can have a tendency to "chase butterflies" – their mind wanders to topics that are tangential to the issue being addressed. The facilitator needs to quickly re-focus the group on the issue at-hand. The facilitator also needs to nip politics in the bud: everyone at the table should have a say on any given issue, but if a team-member continues to repeat his or her position, that's politicking, not problem-solving, and it needs to be addressed. Finally, the facilitator needs to keep any conflicts or debates focused on the issue, rather than on the person who has an opposing view-point.

The team leader also has an important role to play or, rather, an important role to avoid: Team Leaders have veto power, but they should rarely, if ever, dictate. Being a "benevolent dictator" may be the most efficient way to make a decision, but it rarely results in the kind of buy-in, commitment and accountability that makes great teams great. Don't *tell* your team what to do, *guide* them to a well-reasoned decision!

Note that a well-facilitated meeting might not look like anything you're used to seeing. If the team is highly functional, and there is a great deal of trust among the team members, there will often be heated debate regarding the best way to resolve any given issue. And that's perfectly fine, as long as 1) it's debated in a respectful manner, and 2) everyone, even the dissenters, agrees to commit to the final solution. A couple more quotes from Lencioni's *Five Dysfunctions* come to mind: [28]

> *"Consensus is horrible. If everyone really agrees on something and consensus comes about quickly and naturally, that's terrific. But that isn't how it usually works, and so consensus simply becomes an attempt to please everyone."*

> *"Every great movie has conflict. Without it, we just don't care what happens to the characters. Meetings should be at least as interesting as the movies. If you cannot learn to engage in productive, ideological conflict during meetings, you are [doomed]."*

If you're interested in assessing your team based on Lencioni's work, you can download a copy of his assessment here.

Finally, your meetings should:

1. **Start on time and end on time.** Few things in business are more disrespectful than making others wait for you to start a meeting (especially if it's *your* meeting). "Go ahead and start without me" basically means "you'll have to start over when I get there". Both imply that the rest of the team members' time isn't as valuable as yours. There are *very* few valid excuses for showing up late to a previously scheduled meeting.

2. **Be distraction-free.** All team members should put their cell phones on stun and out of reach. Ditto computers, unless you're the Scribe and you're updating the Scoreboard and Commitment List in real-time. No-one should be checking emails or texts. Lock the door, and demand that everyone give their full attention to the meeting (if they're bored or inattentive then, perhaps, they're the wrong person for the seat).

3. **Take no hostages.** Nothing will derail a meeting faster than one person trying to dominate the conversation. If someone tries to do so, call him out. Say something along the lines of, "While we appreciate your contributions and passion for the issue, we need to get input from everyone else so that we can make a decision." Be public about it. Establish and uphold a "no politicking" ground rule early on.

The Roll-out.

At some point, you and your Leadership Team will be comfortable enough with the various components of Focus Four™ to start involving the rest of the organization. Some companies are ready for roll-out in just a few months; others aren't ready until a year or more has passed. You'll know you're ready when your Leadership Team is demonstrably living your Core Values, knocking down one rock after another, and generally acting like a highly cohesive team.

The roll-out is extremely important: Not just from a goal-getting perspective, but also because it can significantly improve morale. According to surveys taken by the Franklin-Covey Group[29], only 15% of surveyed employees knew what their goals were, over 80% said they were not held accountable for their goals, and 87% had no idea what they should be doing to achieve their goals! Those are frightening statistics, especially when you consider that they meet the three criteria for a miserable job[30]:

- **Anonymity:** Employees feel anonymous when the company shows little interest in them as people with unique lives, aspirations and interests. People cannot be fulfilled in their work if they do not feel known.
- **Irrelevance:** Employees feel irrelevant when they can't see how their job makes a difference. People need to know that their jobs matter to someone.
- **Immeasurement:** Employees need to be able to gauge their own progress and level of contribution. People cannot be fulfilled in their work if their success depends entirely on the opinions or whims of another person.

You have two choices with the roll-out: You can roll-out the Scorecard, quarterly Rock-setting and Weekly meeting processes to the rest of the organization exactly as described above for the Leadership Team. Or, you can roll-out a simpler version as described below. We prefer the simpler version because, well, it's simpler, and – most importantly – it's well-aligned with the tactical *Whirlwind* that most employees live in.

Where a 90-day focus makes perfect sense for a Leadership Team that has a more *strategic* role in guiding a company to profitable growth, the rest of the organization is usually *tactically*-focused on the day-to-day *Whirlwind*. As such, a 90-day goal-setting time frame is often too long for them, primarily because many of the rock-supporting tasks that occur at the tactical level take significantly less than 90 days to accomplish. In addition, having shorter-term goals at the tactical level allows for a great deal of flexibility in adjusting those goals to account for unanticipated events.

We recommend the following approach to rolling out Focus Four™ to the rest of the organization:

1. Present your Vision Speech to the entire organization.

2. Have each member of the Leadership Team meet with their direct reports to answer questions about the Vision Speech and to review the company's annual goals and quarterly rocks. Also, have the team determine a time, day and place that it can meet each week for 5 – 15 minutes (see below).

3. During the meeting, ask each team member to make a Team Commitment – something they're going to do during the next 7 days above-and-beyond the *Whirlwind* – that will contribute to

accomplishing one of the departmental Rocks. Make sure that each team member understands that they're making a commitment to themselves and the team – something they're expected to accomplish "no matter what". Also make sure the commitments are SMART.

4. Use the Team Commitment tracker (that follows) to record each team member's commitment.

5. Then, schedule a series of "weekly huddles" – same time, same day, same place, every week. If the "team" consists of just one direct report, schedule 5 minutes per week. If the team is larger, schedule 10 – 15 minutes each week. During the huddle, have each team member report what s/he accomplished and, then, commit to another goal for the upcoming week. Again, it's very important that the team member(s) be involved in the weekly goal-setting process ("team leaders can veto, but not dictate"). This ensures buy-in, and provides for a "no excuses" environment. Also, make sure that you constantly update the team on the progress it's making toward attaining the overall department rock (and how doing so is helping the company achieve its Vision). This is tremendously important! As noted above, employee moral benefits significantly from constant reminders about why their work matters.

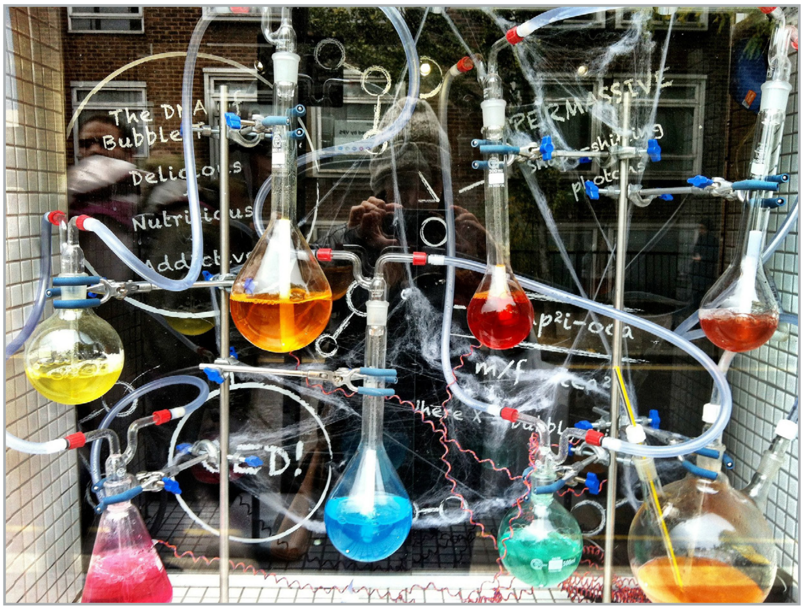
6. Update the Team Commitment tracker and distribute it to all team members. Again, you want the team to be able to see whether or not their weekly commitments are contributing to making progress toward the department's quarterly rock(s).

WEEKLY TEAM COMMITMENTS

WHO	WHAT	WHEN	WHY (DEPT. ROCK)	PROGRESS

Get to Work

SYSTEMS



A system is a collection of related processes. Most businesses have four or five core systems which, unsurprisingly, relate directly to the core seats on the Responsibility Chart.

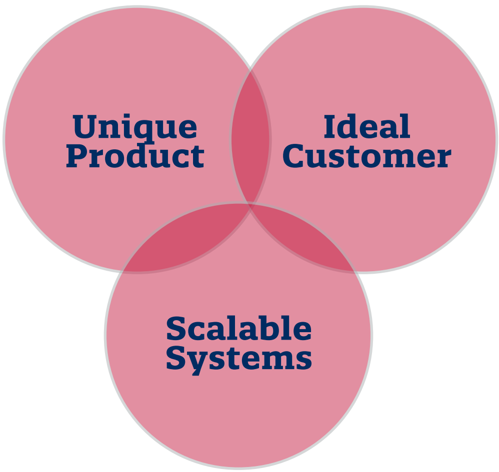
Within each of those systems are several processes. For example, your Cash Management system is comprised of an invoicing process, a collections process, and a month-end close process to name just a few. Focus Four™, for another example, is comprised of planning and leadership processes, among others.

Efficient, effective and repeatable systems and processes help to ensure that you and your team are routinely doing the right things right. For example, they'll help you:

- ✓ Scale your business faster and with less chaos.
- ✓ Increase your company's profitability by enabling you to identify and eliminate operational inefficiencies.
- ✓ Attract higher valuations. When it's time to transition your business to a new owner (and, if you're successful, that time will come sooner or later), you can simply hand the owner a "Recipe Book" of your company's systems and processes that documents exactly what makes your business tick.

In addition, formalized systems and processes are the key to your personal freedom. The more you can standardize your core systems so that they can run without your direct involvement, the more time you'll have to do other things (like work *on* the business, take a long vacation or do something else entirely).

In *The Pumpkin Plan*, Mike Michalowicz defines a company's Sweet Spot as the point where a company's Systems converge with its Unique Product Offering and Ideal Customer (i.e., its Niche). He further notes that "companies that hone and focus on their Sweet Spot are virtually un-stoppable". [31]



That's the good news. The bad news is that systems and processes will provide the benefits outlined above if-and-only-if they're documented; and, unfortunately, there is no effective shortcut to systems documentation. You don't have to capture every minute process activity in detail, but you do have to capture enough detail so that someone unfamiliar with the process (like a new employee) can understand the process with minimal oversight.

Systems often crisscross back-and-forth between different functions and, as such, it can sometimes be difficult to assign ownership. One way to do so is to use a "System Accountability Chart"[32], which can help you track your Core Systems, their related processes, as well as the people accountable for maintaining and documenting them:

SYSTEM ACCOUNTABILITY CHART

Core System	Related Process	Person Accountable	Last Review Date	Documented Yes/No	KPIs
Sales					
Operations					
Finance/ Accounting					

*Most Process KPIs should be measured in terms of time (e.g., numbers of days to deliver, or hours to produce).

The key to documenting your systems is patience. Eat the elephant one bite at a time: It's going to take a while! Also, don't hesitate to call on the SBDC again. We have several process experts and there's nothing they'd like better than to work with you to document your core systems!

In general, follow these steps:

1. **Identify the key processes within each of your Core Systems.** Add them to the Systems Accountability Chart.

2. **Determine who owns each process.** Many processes flow across several functional areas. That's part of the reason why they can become so inefficient. Assign one owner and add that person to the worksheet. Do not assign multiple owners – if more than one person owns the process, nobody owns the process!

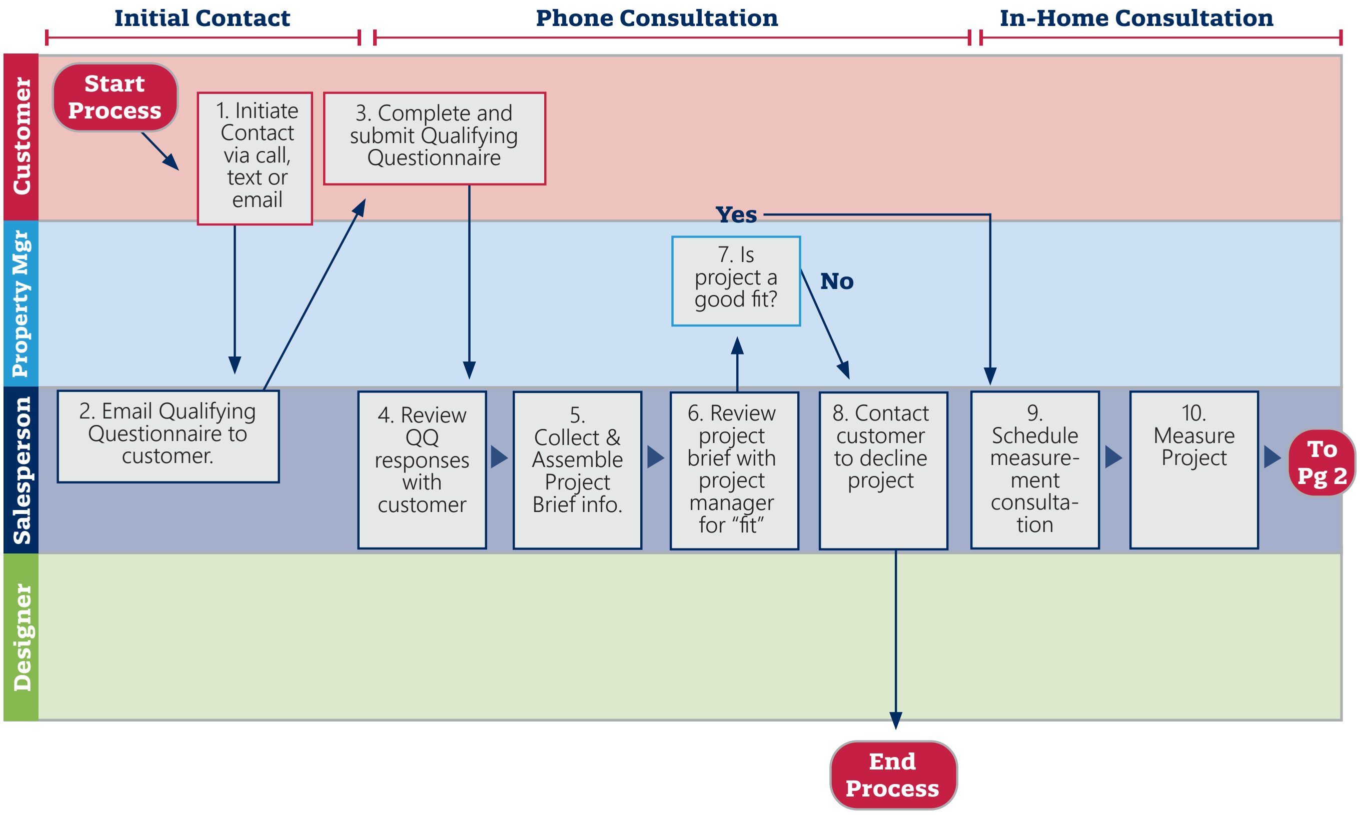
3. **Determine which process to document first.** You probably know which processes are least efficient. That's often a good place to start. If you're not certain, start with either your most expensive process – the one that utilizes the most man-hours or other resources – or the process that's most important to your customers.

4. **Outline the process.** Create a detailed flowchart of the process. Start at the end: what is the desired result (output) of the process? Then, work backwards – step-by-step, activity-by-activity –

to the starting point. Document every activity that occurs from the time the process starts (including the triggering mechanism) until it produces the desired output. Also record the time it takes to perform each activity.

5. **Identify unnecessary activities.** You'll probably find several unnecessary steps when you create your flowchart. Brainstorm for other process improvement ideas (look at the activities that take the longest and/or involve the most people). This will help you identify sources of waste - wasted time, wasted product, even wasted movement (which translates into time & energy).

Sales Process: Example Co.



6. **Create a checklist.** Add each activity, in sequence, to a checklist.

7. **Name the process.** And add it to your Leadership Team Manual.

8. **Train everyone who touches the process.**

9. **Periodically review and update.** Just like a computer's hard drive, processes and systems tend to get fragmented over time. Once you get all of your Core Systems documented the first time, you'll want to revisit one system (and all of its processes) per quarter. This will ensure that every core process gets reviewed biennially.

Example Co. Sales Process / Checklist

Phase	Delegate	#	Process Step
START PROCESS			
Initial Contact	Customer	1	Contact via call, text, or email.
	Salesperson	2	Email QUALIFYING QUESTIONNAIRE (QQ) to customer.
	Customer	3	Complete and submit QQ.
Phone Consult	Salesperson	4	Review QQ responses with customer.
	Salesperson	5	Collect and assemble PROJECT BRIEF info.
	Salesperson	6	Review project brief with project manager for "fit".
	Project Manager	7	Determine if project is a good fit for company (YES or NO).
	Salesperson	8	If Step 7 is NO – Contact customer to decline project.
	Salesperson	9	If Step 7 is YES – Schedule measurement consultation with customer.
In-Home Consult	Salesperson	10	Measure project at customer's location.
	Salesperson	11	Review measurements with project manager.
	Salesperson	12	Create and send INITIAL ESTIMATE & SCOPE to customer.
	Customer	13	Approve initial estimate (YES or NO).
	Salesperson	14	If Step 13 is NO, re-work estimate.
Design Phase	Salesperson	15	If Step 13 is YES, create and send DESIGN/ LAYOUT AGREEMENT and fee to customer
	Customer	16	Sign design/layout agreement, pay fee (YES or NO).
	Salesperson	17	If Step 16 is NO, re-work design/layout agreement.
	Salesperson	18	If Step 16 is YES, schedule and attend design/layout meetings.
	Designer	19	Attend design/layout meetings.
	Designer	20	Create and send DESIGN/LAYOUT AGREEMENT to customer
	Customer	21	Approve design/layout agreement.
	Salesperson	22	If Step 21 is NO, re-work design/layout agreement.
	Salesperson	23	If Step 21 is YES, schedule and attend interior design meetings.
	Designer	24	Attend interior design meetings.
	Salesperson	25	Add/update PAYMENT PLAN
Contact Phase	Salesperson	26	Create and send FINAL QUOTE to customer
	Customer	27	Sign CONTRACT
	Salesperson	28	Record payment; deposit in bank.
	Salesperson	29	Create BINDER.
	Salesperson	30	Upload all documents to Google Docs.
End Process			

YOUR MOST IMPORTANT PROCESS?

> **"Don't be afraid to say no to projects. Prove that you're serious about specialization by turning down work that falls outside your area of expertise. The more people you say no to, the more referrals you'll get to people who need your product or service."**
>
> **John Warrillow, Built to Sell (Creating a Business that can Thrive without You).**

In "Built to Sell", John Warrilow describes a service company (ad agency) that is in complete disarray[33]. The owner has decided it's time to sell the business but discovers that it's essentially worthless because it's completely dependent upon his constant involvement in virtually every aspect of the business. The underlying reason for this constant involvement is that he hasn't built any scalable processes. In other words, all of his offerings are customized based upon the demands of his clients.

His close friend, who has a great deal of experience in scaling (and selling) businesses, advises him to identify a single service that his firm can do better than anyone else, to develop a "proven process" around that service offering, and to focus his efforts on building an organization that can consistently, efficiently and profitably deliver the service.

After getting feedback from several clients and prospects, the owner decides that he can produce logos better than anyone else, and he develops a 5-Step process for creating and delivering them: Visioning, Personification, Sketch Concepts, Proofs, and Final Design. While initially skeptical, he quickly discovers that his process-driven logo design offering is – by far – his most profitable (and fastest growing) service offering.

He also discovers that organizational chaos starts to diminish. He no longer needs a staff of generalists who can handle every ad-hoc client demand. And he no longer needs to plan, direct and supervise a myriad of unique projects. Instead, he can train a very small handful of people to deliver his 5-Step Logo process, and focus his energies almost exclusively on growing his new "product".

The result is a business that is easily monetized. Not just because its new, process-oriented, service-offering can be efficiently scaled and consistently delivered without the owner's constant involvement; but also because the streamlined business model is significantly more profitable than his original model.

Focus 4 – Cash Flow

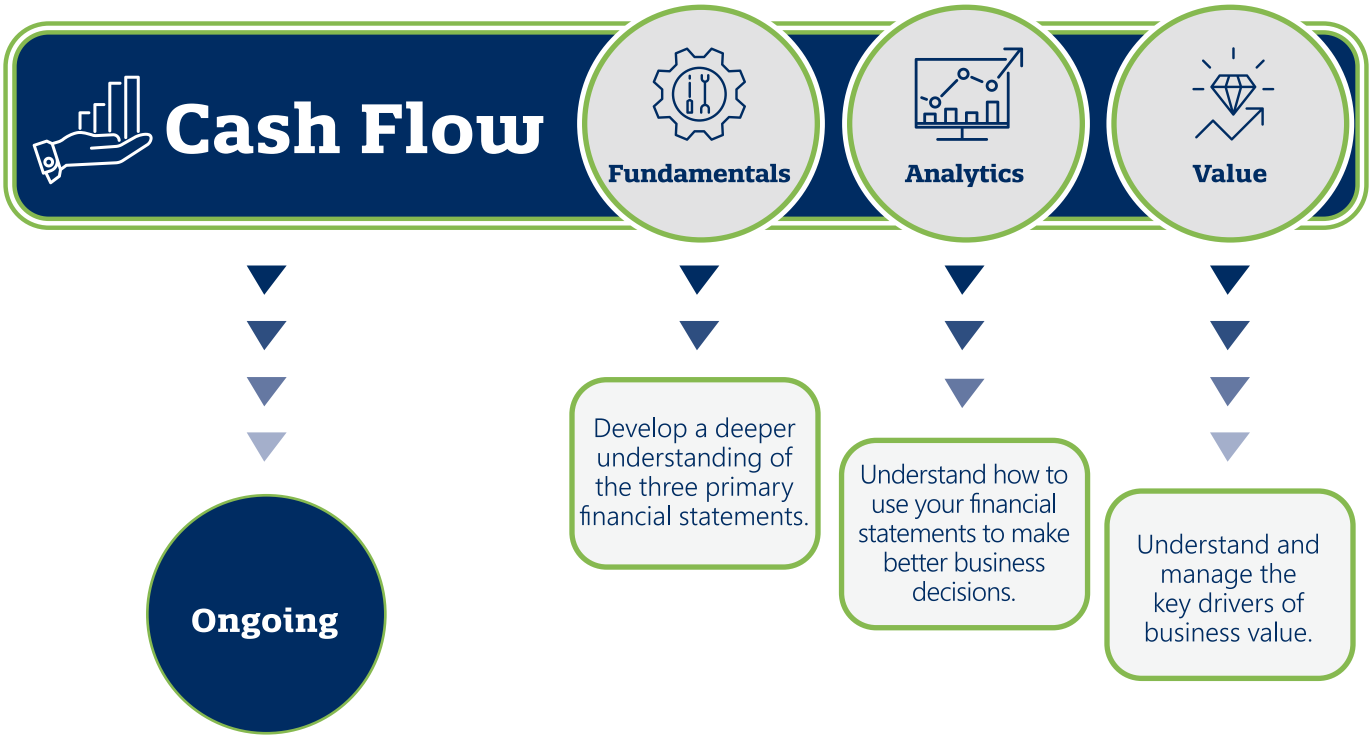
Focus 4 – Cash Flow

> **"If I had to run a company on three measures, they would be customer satisfaction, employee satisfaction and cash flow." Jack Welch**

Cash flow is the lifeblood of business. It's also the foundation upon which most business decisions should be made: Cash flow, not profit, is the true indicator of economic success.

Unfortunately, many small business owners don't have a complete understanding of what drives cash flow, how to fully evaluate it and, most importantly, how to improve it. It makes us cringe to think about how many times we've run into multi-million-dollar companies whose owners are "managing" their businesses out of their checkbooks; how much money they're leaving on the table, how many opportunities they've missed, and what the consequences could be if the IRS decided to audit them. All because they didn't want to spend a few hundred dollars each month on a good bookkeeper!

To fully understand cash flow, you need to have an in-depth understanding of the three primary financial statements: the Income Statement, the Balance Sheet and the Statement of Cash Flows. If you're comfortable with the three statements, skip the section that follows – "Fundamentals" – and dive into the next section – "Analytics".



FUNDAMENTALS

There are three primary financial statements:

1. The Balance Sheet (aka the Statement of Financial Position),
2. The Income Statement (aka the Profit & Loss Statement or, simply, "P&L"), and
3. The Statement of Cash Flows.

> **"One of the earliest lessons I learned in business was that balance sheets and income statements are fiction; cash flow is reality."**
>
> **- Chris Chocola**

The Balance Sheet. In simplest terms, the balance sheet shows the investments you've made in your company and how those investments were financed. It's a snapshot at a specific point in time of all your company's assets (at cost), the liabilities that were incurred to finance those assets, as well as the owner's contribution to financing those assets ("owner's equity").

It's called a balance sheet because it needs to balance: the sum total of your assets should always equal the sum total of your liabilities and owner's equity. This not only helps to ensure that your books are correct, but also is a logical requirement: the cost of your investments (use of funds) should always equal how you paid for them (source of funds). Formulaically, the balance sheet can be stated as follows:

Assets = Liabilities + Owners Equity

or

What you Own = How it was Paid for

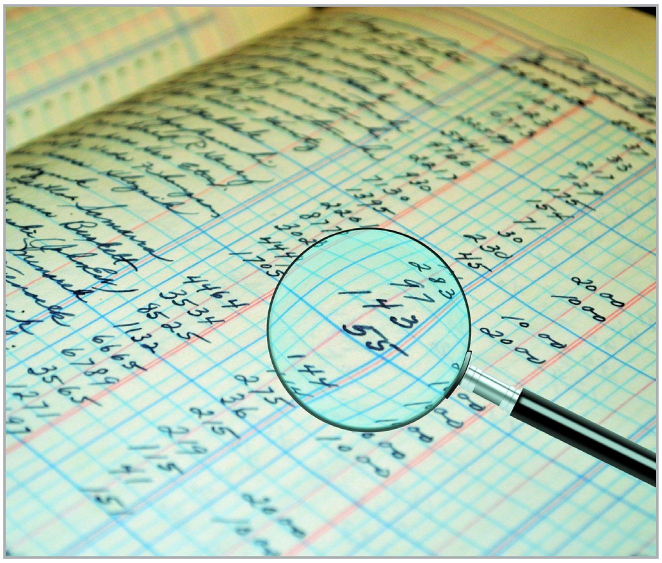
The Income Statement. The P&L shows the net return that you've earned on your investments (assets). In contrast to the balance sheet which, again, is a snapshot at a particular point in time, the P&L is a statement that reflects activity *during* some period of time. Most often, that period of time is a month, a quarter or a year. Formulaically, the income statement can be stated as follows:

Sales (Revenues) – Expenses = Net Income

Note that "Net Income" is an *accounting* return. Depending upon how your sales and expenses are accounted for, it may or may not bear a close relationship to your company's *economic* (cash) returns. Some companies account for their transactional activities on a "cash basis". With this approach, revenues are recorded when the company gets paid for its products or services, and expenses are recorded when the checks are written. This is, perhaps, the easiest way to track receipts and disbursements, but it also tends to distort the company's financial position because it ignores non-cash transactions.

For example, if a cash-basis company sells products on 30-day terms, those sales wouldn't be recorded until they're collected, even if certain costs were incurred to produce the products that were sold. This can have the effect of under-stating revenues relative to costs. Similarly, if a cash-basis company charges some of its expenses to a credit card, those expenses won't be recorded until the credit card is paid, which can result in under-stating costs relative to revenues.

The alternative to cash-basis accounting is accrual-based accounting. With accrual-based accounting, revenues are recorded when they're *earned* and costs are recorded when *incurred*, regardless of when cash is actually received or disbursed. For example, if an accrual-based company sells products on 30-day terms, those sales would be immediately recorded along with a matching receivable. When the cash is collected, the receivable would be eliminated. Similarly, any expenses charged to a credit card would be immediately recorded, along with a payable (to the credit card company). When the credit card is paid, the payable would be eliminated.



From an analytical perspective, accrual-based financials are far more useful than cash-basis financials. In the examples that follow, we'll be using accrual-based financial statements.

The Statement of Cash Flows. The Cash Flow Statement is, fundamentally, nothing more than a reconciliation of cash. It tracks the sources and uses of cash from one period to the next, by activity: Operating Activities, Investing Activities and Financing Activities. Of the three financial statements, it's the only one that focuses on economic (cash) returns rather than accounting returns.

An Example. To get a better idea of how the three statements work, let's build a company from scratch and see how the activities of starting and running a business translate into the various financial statements.

Several years ago, we were approached by an individual – let's call him Mike – who wanted to build guitars for a living. As a long-time musician and avid luthier (who had long since given up the idea of becoming a rock 'n roll star), Mike had recently reached his goal of saving enough money ($25,000) to open up shop.

Once the LLC paperwork was out of the way (he decided to name the business "Mike's Guitar Shop"), Mike deposited the money he'd saved into his new business checking account. The resulting "opening" balance sheet looked like this:

Mike's Guitar Shop
Opening Balance Sheet - INTERIM

ASSETS		LIABILITIES & EQUITY	
Cash	$ 25,000	Accounts Payable	
Accounts Receivable		Current Maturities	
Inventory		Current Liabilities	$ -
Current Assets	$ 25,000		
		Long-term Debt	
Leaseholds		Less: Current Maturities	
Furniture, Fixtures & Equip		Total L/T Liabilities	$ -
Less: Acc'd Depreciation			
Total Fixed Assets	$ -	Owner's Equity	$ 25,000
Total Assets	$ 25,000	Total Liabilities & Equity	$ 25,000

Note that both sides of the balance sheet are in-balance. In accounting, every transaction has two components – a "debit" and a "credit" – which most often correspond to the use and the source of funds. In this example, the source of funds (credit) is the owner's contribution and the use of funds (debit) is simply a deposit in his business checking account.

Mike then made a list of all the assets he was going to need to get his newly formed business up and running:

Inventory	$ 50,000
Equipment	50,000
Furniture & Fixtures	20,000
Leasehold Improvements	20,000
Working Capital (Cash)	10,000
TOTAL	**$150,000**

His next order of business was to get a loan approved. He'd need $125,000 and was able to secure an SBA-guaranteed loan thanks to 1) a relatively large down payment, 2) excellent credit, and 3) a well-thought-out financing package.

As soon as the loan was approved and disbursed, Mike's bookkeeper made the appropriate entries in QuickBooks, which resulted in the following:

Mike's Guitar Shop
Opening Balance Sheet - INTERIM

ASSETS		LIABILITIES & EQUITY	
Cash	$ 150,000	Accounts Payable	
Accounts Receivable		Current Maturities	9,887
Inventory		Current Liabilities	$ 9,887
Current Assets	$ 150,000		
		Long-term Debt	125,000
Leaseholds		Less: Current Maturities	(9,887)
Furniture, Fixtures & Equip		Total L/T Liabilities	115,113
Less: Acc'd Depreciation			
Total Fixed Assets	$ -	Owner's Equity	25,000
Total Assets	$ 150,000	Total Liabilities & Equity	$ 150,000

Again, note that the balance sheet remains in-balance. The loan proceeds (the "source" of funds) were balanced by an offsetting entry to cash (the "use" of funds).

At this point, Mike's Guitar Shop was sitting on $150,000 in cash which he used to purchase inventory and equipment:

Mike's Guitar Shop
Opening Balance Sheet - FINAL

ASSETS		LIABILITIES & EQUITY	
Cash	$ 10,000	Accounts Payable	
Accounts Receivable		Current Maturities	9,887
Inventory	50,000	Current Liabilities	$ 9,887
Current Assets	$ 60,000		
		Long-term Debt	125,000
Leaseholds	20,000	Less: Current Maturities	(9,887)
Furniture, Fixtures & Equip	70,000	Total L/T Liabilities	115,113
Less: Acc'd Depreciation			
Total Fixed Assets	$ 90,000	Owner's Equity	25,000
Total Assets	$ 150,000	Total Liabilities & Equity	$ 150,000

During his first month of operation, Mike was able to sell $10,374 worth of guitars. His other expenses included rent, utilities, internet-related expenses and advertising. He also paid himself $1,000. In addition, his bookkeeper recorded some depreciation expense. Depreciation is a non-cash expense that reflects the write-down of assets over their useful lives. For example, if Mike's leasehold improvements are expected to last for 15 years, he'd write-off the cost of those assets by 1/15th each year. At the end of the month, Mike's P&L looked like this ☞

Two items are particularly noteworthy. First, remember that Mike borrowed $125,000 from the bank. Assuming a 5% rate of interest and a 10 year term, that's a monthly payment of $1,326. Part of that payment is interest ($521) and part of that payment is principal ($805). The only part that shows up on the P&L is the interest expense. The principal payment is not considered an expense but, rather, a return of capital (to the bank) and, as such, it will show up on the balance sheet as a decrease in the loan amount.

The second noteworthy item is Mike's $1,000 "salary". Because Mike's Guitar Shop is an LLC, all earnings are "passed through" to his personal tax return and any "salary" that Mike pays himself is also considered a return of capital (this time to Mike, rather than to the bank). As such, the $1,000 that Mike paid himself will not show up on the P&L. It will show up as a "draw" on the balance sheet (i.e., a reduction in owner's equity).

Mike's Guitar Shop
Opening Balance Sheet - FINAL

	ONE MONTH ENDING 1/31/X1	
Sales	$ 10,374	100.0%
Cost of Goods Sold	6,318	60.9%
Gross Profit	$ 4,056	39.1%
S,G & A Expense		
Advertising/Marketing	1,150	11.1%
Bank Service Charges	36	0.3%
Depreciation	500	4.8%
Insurance		
Internet/Web Related	99	1.0%
Meals & Entertainment		
Payroll		
Payroll Taxes		
Professional Services	250	2.4%
Repairs & Maintenance		
Rent	1,500	14.5%
Shop Supplies	160	1.5%
Travel		
Utilities	484	4.7%
Other		
Total S,G & A Expense	4,178	40.3%
Operating Income	$ (122)	-1.2%
Other (Inc) / Exp:		
Interest Expense	521	5.0%
Miscellaneous	-	0.0%
Total Other	$ 521	5.0%
Net Income	$ (643)	-6.2%

The result, was a month-end balance sheet that looks like this:

Mike's Guitar Shop
Balance Sheet As of 1/31/20X1

ASSETS		LIABILITIES & EQUITY	
Cash	$ 837	Accounts Payable	
Accounts Receivable	10,374	Current Maturities	9,928
Inventory	46,841	Current Liabilities	$ 9,928
Current Assets	$ 58,052		
		Long-term Debt	124,195
Leaseholds	20,000	Less: Current Maturities	(9,928)
Furniture, Fixtures & Equip	70,000	Total L/T Liabilities	114,267
Less: Acc'd Depreciation	(500)		
Total Fixed Assets	$ 89,500	Owner's Equity	23,357
Total Assets	$ 147,552	Total Liabilities & Equity	$ 147,552

At first glance, you might be asking yourself: How is it that the balance sheet shrank by almost $2,500 ($150,000 - $147,552 = $2,448) when the business lost only $643? That's a really good question! Starting at the bottom, here's how each line-item reconciles to the prior balance sheet:

1. **Owner's Equity (OE).** OE reflects two things: ongoing earnings (retained earnings) and owner contributions/draws. In this case, OE reconciles as follows:

Reconciliation of Owner's Equity	
Beginning Balance	$25,000
Plus: Net income (Loss)	(643)
Less: Owner's Draws	(1,000)
Plus: Additional Contributions	-
TOTAL	**$23,357**

2. **Total Liabilities.** At this point, the only liability that Mike's has is his bank loan. His January loan payment was $1,326, of which $805 was a reduction in his loan balance (remember, the interest on his loan gets booked to the P&L). Note that current maturities increased slightly versus the prior month's balance sheet. Current maturities represent the total amount of principle that is due within the next 12 months. As Mike continues to make payments on his loan (and reduce his loan balance), less of his monthly payment will go to interest expense, and more will go toward principle reduction.

3. **Net Fixed Assets.** Fixed assets were reduced (depreciated) by $500. This number assumes a 15 year "useful" life for the leaseholds, furniture, fixtures and equipment that Mike purchased: $90,000 / 15 = $6,000 in annual depreciation (or $6,000 / 12 = $500 per month). Depreciation is a *non-cash* charge. It's an accounting entry used to estimate the decrease in value of fixed assets as they're used in the business over time. The P&L shows the monthly charge, and the balance sheet shows the accumulated total. In other words, in his second month of operation, Mike's bookkeeper will record another $500 of depreciation expense, and the balance sheet will reflect the accumulated total of $1,000.

4. **Accounts Receivable.** Mike gives his customers 30 days to pay their invoices so, as of the end of his first month in business, he hadn't collected any of his invoices.

5. **Inventory.** Mike didn't replenish any inventory during his first month of business, so it declined from $50,000 to $46,841.

6. **Cash.** Cash decreased from $10,000 to $837 as the accompanying Cash Flow Statement demonstrates. ☞

As noted earlier, the Cash Flow Statement is a reconciliation of cash from the end of one period to the end of the next. In this case, we're reconciling cash from Mike's opening balance sheet to the end of his first month of operation. Note that the first two lines on the Cash Flow Statement (Net Income and Depreciation Expense) come directly from the P&L. Everything else comes from the balance sheet: specifically, the *change* in balances for every line item on the balance sheet.

For example, if you look at the opening balance sheet, accounts receivable (A/R) was $0. At the end of his first month of operations, A/R had increased to $10,374. An increase in A/R is a use of cash – essentially, Mike is loaning money to his customers – so it shows up as a negative number on the Cash Flow Statement. Similarly, Mike's inventory decreased from $50,000 to $46,841, so the Cash Flow Statement shows the $3,159 change in inventory. Selling inventory is a *source* of cash, so the number is positive.

Mike's Guitar Shop Statement of Cash Flows

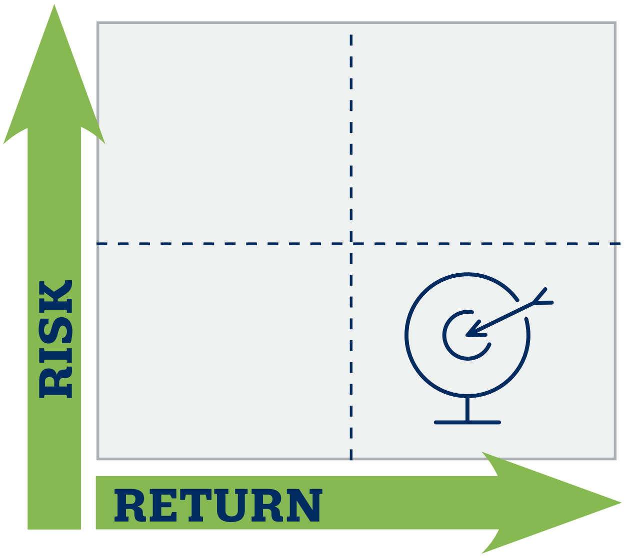
	SINCE OPENING
NET INCOME	$ (643)
PLUS / (LESS):	
Depreciation	500
Change in:	
Accounts Receivable	(10,374)
Inventory	3,159
Accounts Payable	-
Cash Flow from Operating Activities	$ (7,358)
PLUS / (LESS):	
Capital Expenditures	-
Proceeds from Sale of Assets	-
Cash Flow from Investing Activities	$ -
PLUS / (LESS):	
Change in Short-term Debt	-
Change in Long-term Debt	(805)
Change in Capital Accounts	(1,000)
Cash Flow From Financing Activities	$ (1,805)
Net Cash Flow	$ (9,163)
RECONCILIATION:	
Beginning Cash	$ 10,000
Ending Cash	837
Change in Cash	$ (9,163)
Unreconciled Difference	$ 0

As noted earlier, the $805 decrease in long-term debt (a use of cash) reflects only the principle portion of Mike's monthly payment. The interest payment is recorded on the P&L as interest expense and, as such, is accounted for in Net Income.

Finally, Mike paid himself $1,000 which, for an LLC, is considered a "return of capital" (a use of cash). As such, those draws never hit the P&L – they come directly from Owner's Equity (think of draws as a dividend).

One final note: Earlier, we introduced the concept of accounting returns (Net Income) versus economic returns (Cash Flow). As you can see in this example, Net Income often represents only a very small portion of a company's Cash Flow. The take-away, for now, is that managing your balance sheet is just as important as managing your P&L; and the Cash Flow Statement provides the key link between the two.

ANALYTICS



The ultimate *economic* measure of a firm's success is the level of return that it earns on the capital invested in it. There are many different measures of return – Return on Equity (ROE), Return on Assets (ROA), and Return on Investment (ROI), to name a few – and they all have their uses. But our favorite measure of return is something called Return on Invested Capital (ROIC) because a) it's relatively easy to calculate, b) it's comprehensive, and c) it can be directly linked to value-creation. As we noted earlier, value-creation is an important concept regardless of your exit plans: if you base your financial decisions on whether they create value for your business, you'll invariably be making sound financial decisions.

Before we jump into the details of ROIC, it's important to have a conceptual understanding of what we're trying to measure. *From a financial perspective*, a business is nothing more (or less!) than an investment. Like any other investment – stocks, bonds, certificates of deposit, etc. – what matters are the after-tax (cash) returns that we earn on that investment. And, importantly, those returns need to compensate the investor (the owner) for the risk associated with that investment.

For example, certificates of deposit offer very low rates of return because they are virtually risk-free: banks rarely default and, when they do, the Federal Deposit Insurance Corporation steps in to cover any losses incurred by depositors. Stocks, on the other hand, are much riskier. As the fine print says, there are no guarantees of future results. As such, they will only attract investors if they offer the potential for higher returns than less risky investments like certificates of deposit.

Small businesses are among the riskiest investments that can be made. The long-term survival rate of small businesses is abysmal: Less than 50% of small businesses survive to see their fifth birthday. As such, the owners of small businesses should expect to earn much higher returns than they could from putting their money into other investments (like, for example, the stock market). How much higher? In most cases, *at least double*. In other words, if the long-term average return of the stock market is 9% - 10% per year, small business owners should expect their businesses to earn *at least* twice that amount to justify the risk of being in business for themselves.

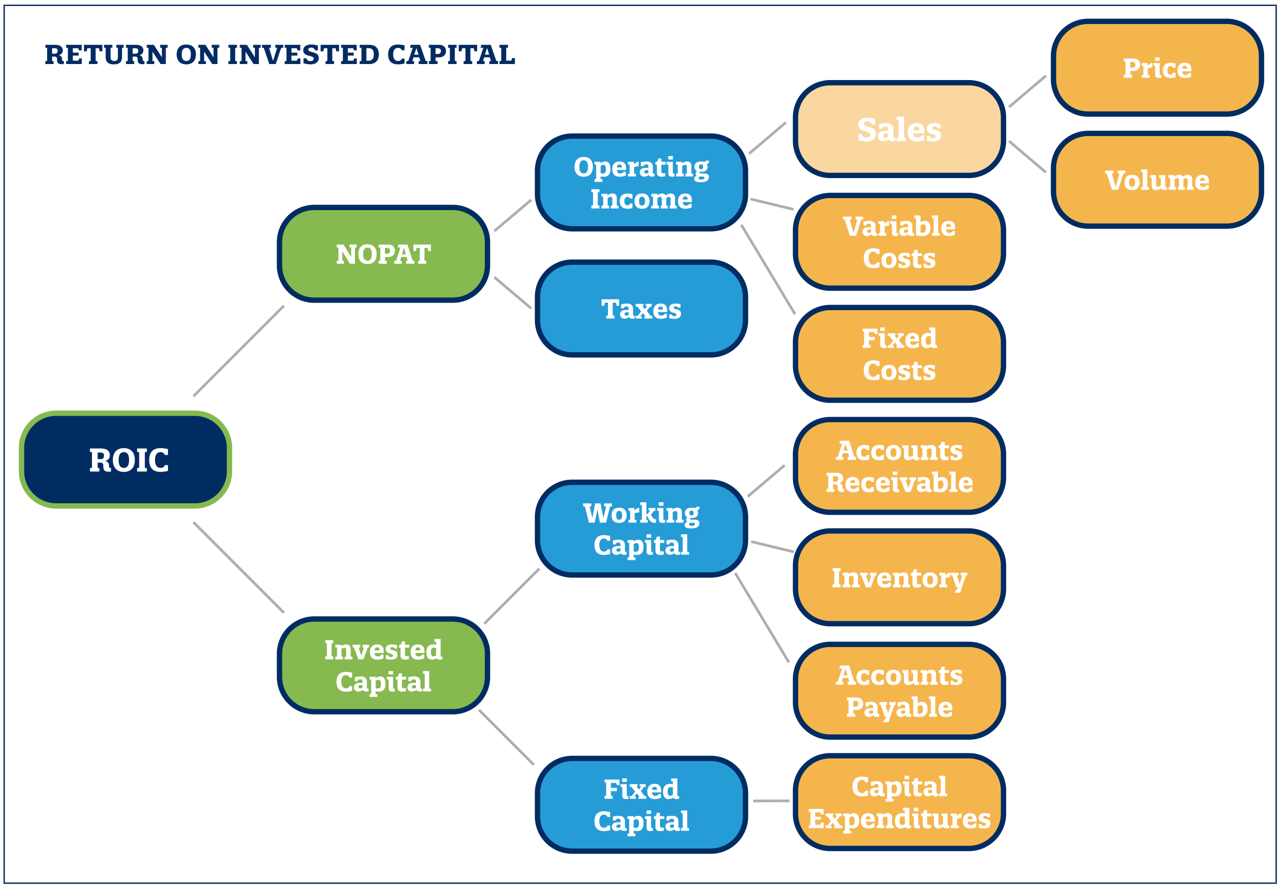
This expected rate of return – which is often referred to as the "hurdle rate" or "the cost of capital" – is the minimum rate of return that a small business needs to generate – *above and beyond a reasonable owner salary* – to financially justify the risk of owning a small business. This minimum rate of return is also the inflection point for creating value: companies that consistently generate less than the hurdle rate destroy value (and, often, go bankrupt), while those that exceed it generally create value. This, in a nutshell, is what ROIC attempts to measure.

ROIC. ROIC is a rather useless measure during a small business's formative years. During the start-up phase, the owner is placing a bet that his or her efforts will have a significant long-term payoff. But as companies approach the million-dollar barrier and enter the early stages of Stage II growth, the measure becomes increasingly important. We see far too many businesses that are barely earning enough cash to pay back the bank, let alone a healthy return on their owners' investment. For Stage II companies, ROIC is not just a measure of value-creation, it's a critical measure of *success*.

ROIC is comprised of two components, "NOPAT" (Net Operating Profit After Tax), and "Invested Capital" (the sum of fixed assets plus operating working capital). It's calculated as follows:

$$\text{ROIC} = \frac{\text{Net Operating Profit After Tax (NOPAT)}}{\text{Invested Capital}}$$

And the concept is simple: You maximize ROIC by managing the eight inputs shown below in **orange**:



The eight inputs are referred to as "Impact Drivers" and, to reinforce a concept introduced during the Execution component of Focus Four™, they represent the *leading* indicators for ROIC.

In the pages that follow, we'll discuss each of the Impact Drivers and how to manage them. Throughout the discussion, we'll be referring to the financials that appear on the following pages.

Mike's Guitar Shop
Income Statement

	12 MONTHS ENDING 12/31/X3		12 MONTHS ENDING 12/31/X4		12 MONTHS ENDING 12/31/X5	
Sales	$ 487,986	100.0%	$ 683,180	100.0%	$ 1,092,208	100.0%
Cost of Goods Sold	244,481	50.1%	364,818	53.4%	613,821	56.2%
Gross Profit	$ 243,505	49.9%	$ 318,362	46.6%	$ 478,387	43.8%
S,G & A Expense						
Advertising/Marketing	5,970	1.2%	8,945	1.3%	9,125	0.8%
Bank Service Charges	1,525	0.3%	1,941	0.3%	2,956	0.3%
Depreciation	6,333	1.3%	14,000	2.0%	14,000	1.3%
Insurance	2,380	0.5%	5,140	0.8%	5,448	0.5%
Internet/Web Related	1,428	0.3%	1,571	0.2%	1,728	0.2%
Meals & Entertainment	1,727	0.4%	2,269	0.3%	2,140	0.2%
Payroll	89,152	18.3%	119,501	17.5%	176,671	16.2%
Payroll Taxes	8,380	1.7%	11,233	1.6%	16,607	1.5%
Professional Services	3,500	0.7%	5,500	0.8%	6,000	0.5%
Repairs & Maintenance	1,249	0.3%	6,607	1.0%	12,588	1.2%
Rent	18,000	3.7%	42,000	6.1%	42,000	3.8%
Shop Supplies	2,445	0.5%	3,648	0.5%	6,138	0.6%
Travel	1,354	0.3%	1,435	0.2%	4,234	0.4%
Utilities	6,297	1.3%	11,334	1.7%	11,618	1.1%
Other	321	0.1%	3,870	0.6%	1,679	0.2%
Total S,G & A Expense	150,061	30.8%	238,995	35.0%	312,932	28.7%
Operating Income	$ 93,444	19.1%	$ 79,367	11.6%	$ 165,455	15.1%
Other (Inc) / Exp:						
Interest Expense	4,988	5.0%	4,428	0.6%	8,662	0.8%
Miscellaneous	-	0.0%	-	0.0%	-	0.0%
Total Other	$ 4,988	5.0%	$ 4,428	0.6%	$ 8,662	0.8%
Net Income	$ 88,456	-6.2%	$ 74,939	11.0%	$ 156,793	14.4%

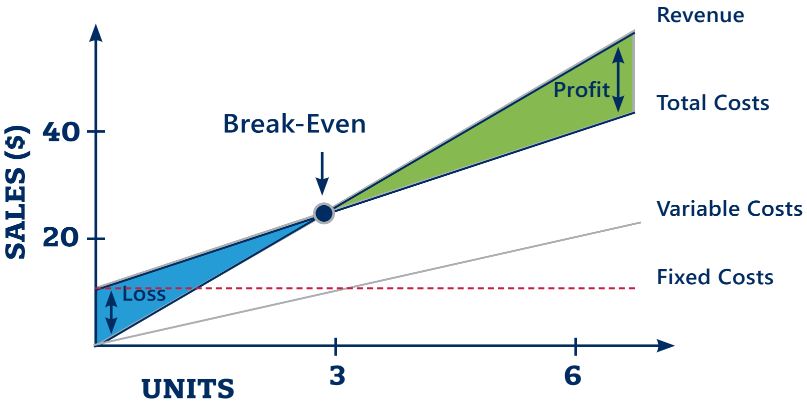
Mike's Guitar Shop
Balance Sheet

	12 MONTHS ENDING 12/31/X3		12 MONTHS ENDING 12/31/X4		12 MONTHS ENDING 12/31/X5	
Current Assets:						
Cash	$ 2,739	1.3%	$ 1,249	0.3%	$ 6,893	1.5%
Accounts Receivable	70,190	33.0%	91,715	25.3%	157,098	34.0%
Inventory	63,632	29.9%	91,954	25.4%	134,536	29.1%
Total Current Assets	$ 136,561	64.1%	$ 184,918	51.0%	$ 298,527	64.6%
Property, Plant & Equipment						
Gross Fixed Assets	95,000	44.6%	210,000	58.0%	210,000	45.5%
Acc'd Depreciation	(18,667)	-8.8%	(32,667)	-9.0%	(46,667)	-10.1%
Net Fixed Assets	$ 76,333	35.9%	$177,333	49.0%	$ 163,333	35.4%
Total Assets	$ 212,894	100.0%	$ 362,251	100.0%	$ 461,861	100.0%
Current Liabilities						
Accounts Payable	42,868	20.1%	60,770	16.8%	91,569	19.8%
Line of Credit	2,000	0.9%	20,000	5.5%	12,000	2.6%
Current Maturities	11,484	5.4%	19,982	5.5%	21,004	4.5%
Total Current Liabilities	$ 56,352	26.5%	$ 100,752	27.8%	$ 124,573	27.0%
Long-term Liabilities	82,313	38.7%	162,331	44.8%	141,327	30.6%
Total Liabilities	$ 138,665	65.1%	$ 263,083	72.6%	$ 265,900	57.6%
Owner's Equity	74,229	34.9%	99,168	27.4%	195,961	42.4%
Net Income	$ 212,894	100.0%	$ 362,251	100.0%	$ 461,861	100.0%

Mike's Guitar Shop
Statement of Cash Flows

	12 MONTHS ENDING 12/31/X3	12 MONTHS ENDING 12/31/X4	12 MONTHS ENDING 12/31/X5
NET INCOME	$ 88,456	$ 74,939	$ 156,793
PLUS / (LESS):			
Depreciation	6,333	14,000	14,000
Change in:			
Accounts Receivable	(20,054)	(21,525)	(65,384)
Inventory	(14,165)	(28,322)	(42,582)
Accounts Payable	11,209	17,902	30,799
Cash Flow from Operating Activities	$ 71,779	$ 56,994	$ 93,626
PLUS / (LESS):			
Capital Expenditures	-	(115,000)	-
Proceeds from Sale of Assets	-	-	-
Cash Flow from Investing Activities	$ -	$ (115,000)	$ -
PLUS / (LESS):			
Change in Short-term Debt	(10,000)	18,000	(8,000)
Change in Long-term Debt	(10,924)	88,516	(19,982)
Change in Capital Accounts	(50,000)	(50,000)	(60,000)
Cash Flow From Financing Activities	$ (70,924)	$ 56,516	$ (87,982)
Net Cash Flow	$ 885	$ (1,490)	$ 5,644
RECONCILIATION:			
Beginning Cash	$ 1,884	$ 2,739	$ 1,249
Ending Cash	$ 2,739	$1,249	$ 6,893
Change in Cash	$ 885	$ (1,490)	$ 5,644
Unreconciled Difference	$ -	$ -	$ -

Managing Sales. There are two Impact Drivers that affect sales: volume and price. Much of the Strategy Component of Focus Four™ is focused on the volume driver – finding the right target market and offering a differentiated product that fills a need or solves a problem. The key, of course, is to offer a *profitable* product. And that's where the second Impact Driver, pricing, plays a critical role.



Most companies that we work with haven't raised their prices in years. When we ask "why?", their owners usually say they can't because, if they did, they'd lose business to their competitors. Setting aside the fact that such a statement suggests the company doesn't have a truly differentiated strategy, we usually just ask them how much business they think they'd lose. And then we show them, using Breakeven Analysis, how much business they could *afford* to lose. Often, they'll discover that the benefit of increasing prices more than offsets the amount of business they might lose.

A company's breakeven is the point at which its sales exactly cover its costs. It's a very useful tool for answering questions like: "If my costs go up, how much do my sales need to increase for me to maintain a profit?" and "If I raise prices, how much sales can I afford to lose?". The formula for breakeven is:

B/E Sales = Fixed Costs / Contribution Margin %

Where

Contribution Margin % = (Sales - Variable Costs) / Sales

Fixed costs are those costs that don't have a direct relationship to sales. In other words, unlike variable costs, they don't increase or decrease just because sales increase or decrease. They're usually categorized as "operating" expenses (or "Selling, General & Administrative" / S,G&A expenses), although not all operating expenses are fixed.

Contribution Margin % reflects the percentage of sales that are available to cover (contribute to) fixed costs. In other words, if every dollar of sales results in $0.40 of variable costs, there's $0.60 left over to cover fixed costs. The formula is much easier to understand by way of example.

The starting point for Breakeven (B/E) Analysis is your P&L and the first step is to classify all of your costs as either "fixed" or "variable". Variable costs are those costs that vary directly with sales – if sales increase, so do variable costs and vice versa. Materials and labor – the primary inputs to Cost of Goods Sold – are good examples of variable costs. Following is how Mike classified his most recent P&L:

Mike's Guitar Shop
Income Statement

	12 MONTHS ENDING 12/31/X5		CLASSIFICATION VARIABLE	FIXED
Sales	$ 1,092,208	100.0%		
Cost of Goods Sold	613,821	56.2%	613,821	-
Gross Profit	$ 478,387	43.8%		
S,G & A Expense				
Advertising/Marketing	9,125	0.8%		9,125
Bank Service Charges	2,956	0.3%	2,956	-
Depreciation	14,000	1.3%		
Insurance	5,448	0.5%		5,448
Internet/Web Related	1,728	0.2%		1,728
Meals & Entertainment	2,140	0.2%		2,140
Payroll	176,671	16.2%		176,671
Payroll Taxes	16,607	1.5%		16,607
Professional Services	6,000	0.5%		6,000
Repairs & Maintenance	12,588	1.2%	3,776	8,812
Rent	42,000	3.8%		42,000
Shop Supplies	6,138	0.6%		6,138
Travel	4,234	0.4%		4,234
Utilities	11,618	1.1%	2,324	9,294
Other	1,679	0.2%		1,679
Total S,G & A Expense	312,932	28.7%		
Operating Income	$ 165,455	15.1%		
Other (Inc) / Exp:				
Interest Expense	8,662	0.8%		28,644
Miscellaneous	-	0.0%		
Total Other	$ 8,662	0.8%		
Net Income	$ 156,793	14.4%	$ 622,877	$ 318,521

Note that the fixed/variable analysis excludes depreciation expense. Since depreciation expense is a *non-cash* charge, including it would distort breakeven. Also note that the analysis includes an amount for interest expense ($28,644) that is significantly higher than what's shown on the P&L. This amount includes both interest expense and principle payments. Since the P&L excludes principle payments – which are fixed – we want to include them in our breakeven analysis to get a truer picture of our fixed obligations.

The next step is to summarize the fixed/variable analysis as follows:

	12 MONTHS ENDING 12/31/20X5	
Sales	$ 1,092,208	100.0%
Variable Costs	622,877	57.0%
Contribution Margin	$ 469,331	43.0%
Fixed Costs	318,521	29.2%
Adjusted "Profit"	$ 150,811	13.8%

And, finally, to calculate B/E Sales, you divide total Fixed Costs by the Contribution Margin % which, in this example, results in B/E Sales of $741,248

B/E Sales = Fixed Costs / Contribution Margin %

$741,248 = $318,521 / 43%

In other words, if Mike's sales fell to $741,248, he would earn just enough margin to cover his fixed costs:

Fixed Costs = B/E Sales X Contribution Margin %

$318,521 = $741,248 X 43%

All of which brings us back to our original question: If Mike raises his prices, how much sales revenue can he afford to lose? The key to answering this question is to note that a price increase will not increase variable costs (or fixed costs, for that matter), but it *will* increase Contribution Margin %. In Mike's case, a 10% increase in prices would increase his Contribution Margin % from 43% to 47.9%.

	PROFORMA	
Sales	$ 1,092,208	
10% Price Increase	$ 109,221	
Proforma Sales	$ 1,201,429	100.0%
Variable Costs	516,264	43.0%
New Contribution Margin	$ 575,944	47.9%

Now, we simply divide Mike's fixed costs by the new Contribution Margin %, to find his new B/E Sales level of $664,440:

B/E Sales = Fixed Costs / Contribution Margin %

$664,440 = $318,521 / 47.9%

What this tells us is that Mike should consider raising his prices by 10% if, by doing so, he expects to lose less than $76,808 in sales.

Original B/E Sales – Proforma B/E Sales = Maximum Affordable Sales Loss

$741,248 - $664,440 = $76,808

B/E analysis can also be a useful tool for understanding the level of sales increase that's needed to cover a planned increase in costs. For example, let's say Mike is considering hiring a new sales person. The new person's compensation package would include an annual salary of $40,000, $4,000 in payroll taxes, a monthly car allowance of $500 and a 10% commission on all new sales. The question is: what's the minimum level of sales increase that would justify the new hire?

In this case, we know that fixed costs are going to increase by $50,000, and we know that Contribution Margin % on all new sales is going to decrease by 10% due to the new commission structure:

Salary	$ 40,000
Payroll Tax @ 10%	4,000
Car Allowance	6,000
Total New Fixed Costs	$ 50,000
Original Contribution Margin %	43.0%
Less: 10% Commission	10.0%
Contribution Margin on New Sales	33.0%
Breakeven Sales ($ 50,000 / 33%)	$ 151,515

And, returning to our B/E formula, we find that the breakeven sales point for hiring a new sales person is $151,515:

B/E Sales = Fixed Costs / Contribution Margin %

$151,515 = $50,000 / 33%

Managing Costs. Controlling fixed and variable costs is an especially important issue for small business owners, most of whom have (very) limited resources and need to make sure that every dollar earned is spent wisely.

One of the most effective tools for managing costs is the annual (cash) budget. The starting point for developing a budget is the "next year" target that you developed as part of the Strategy Component. In Mike's case, he estimated that he would earn $223,692 on sales of $1.4 million, as shown. ☞

For a budget to be truly effective, however, it needs to be 1) detailed by month, 2) cash-based, and 3) owned.

Detailed by Month. Monthly detail is important for two reasons. First, to be an effective control document, you'll want to compare your company's actual monthly results to your monthly budget. Second, the monthly detail will reveal any interim cash shortfalls due to variables like sales seasonality, the timing of certain large expenditures (such as property taxes), and the impact of new product launches. As the monthly budget on the following page demonstrates, Mike's faces a pretty severe sales slump following the holiday season, and his cash flow takes a pretty significant hit early in the year.

Cash-based. Note that the monthly cash budget is simply a modified version of the Cash Flow Statement. It details everything on the P&L (through operating income), and then accounts for depreciation, working capital and loan payments.

Mike's Guitar Shop
Next Year's Target

	12 MONTHS ENDING 12/31/X6	
Sales	$ 1,441,715	100.0%
Cost of Goods Sold	798,710	55.4%
Gross Profit	$ 643,005	44.6%
S,G & A Expense		
Advertising/Marketing	10,200	0.7%
Bank Service Charges	3,716	0.3%
Depreciation	17,333	1.2%
Insurance	5,993	0.4%
Internet/Web Related	1,901	0.1%
Meals & Entertainment	2,680	0.2%
Payroll	260,505	18.1%
Payroll Taxes	24,487	1.7%
Professional Services	6,500	0.5%
Repairs & Maintenance	11,232	0.8%
Rent	42,000	2.9%
Shop Supplies	7,987	0.6%
Travel	4,488	0.3%
Utilities	11,908	0.8%
Other	742	0.1%
Total S,G & A Expense	411,673	28.6%
Operating Income	$ 231,332	16.0
Other (Inc) / Exp:		
Interest Expense	7,640	0.5%
Miscellaneous	-	0.0%
Total Other	$ 7,640	0.5%
Net Income	$ 223,692	15.5%

Mike's Guitar Shop - Cash Budget By Month

FOR THE YEAR ENDING 12/31/X6

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	TOTAL
Sales	$ 114,616	$ 107,984	$ 99,334	$ 117,356	$ 117,932	$ 120,383	$ 127,303	$ 115,626	$ 121,537	$ 119,806	$ 132,494	$ 147,344	$ 1,441,715
Cost of Goods Sold	63,497	59,823	55,031	65,015	65,334	66,692	70,526	64,057	67,331	66,373	73,402	81,629	798,710
Gross Profit	$ 51,119	$ 48,161	$ 44,303	$ 52,341	$ 52,598	$ 53,691	$ 56,777	$ 51,569	$ 54,209	$ 53,433	$ 59,092	$ 65,715	$ 643,005
S,G & A Expense													
Advertising/Marketing	750	750	750	750	750	750	750	750	1,050	1,050	1,050	1,050	10,200
Bank Service Charges	295	278	256	302	304	310	328	298	313	309	342	381	3,716
Depreciation	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	17,333
Insurance		2,548					3,445						5,993
Internet/Web Related	158	158	158	158	158	158	158	158	158	158	158	158	1,901
Meals & Entertainment	223	223	223	223	223	223	223	223	223	223	223	223	2,680
Payroll	15,459	15,459	15,459	15,459	24,834	24,834	24,834	24,834	24,834	24,834	24,834	24,834	260,505
Payroll Taxes	1,453	1,453	1,453	1,453	2,334	2,334	2,334	2,334	2,334	2,334	2,334	2,334	24,487
Professional Services	300	300	300	300	300	300	300	300	300	300	300	300	6,500
Repairs & Maintenance	500	500	500	500	500	500	5,732	500	500	500	500	500	11,232
Rent	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	42,000
Shop Supplies	635	598	550	650	653	667	705	641	673	664	734	816	7,987
Travel	400	400	400	400	400	400	400	1,688					4,488
Utilities	1,075	1,120	950	875	825	880	1,090	1,240	975	925	950	1,003	11,908
Other	62	62	62	62	62	62	62	62	62	62	62	62	742
Total S,G & A Expense	$ 26,255	$ 28,794	$ 26,255	$ 26,255	$ 26,255	$ 26,255	$ 26,255	$ 26,255	$ 26,255	$ 26,255	$ 26,255	$ 26,255	411,673
Operating Income	$ 24,864	$ 19,367	$ 24,864	$ 24,864	$ 24,864	$ 24,864	$ 24,864	$ 24,864	$ 24,864	$ 24,864	$ 24,864	$ 24,864	$ 231,332
Cash Adjustments:													
Depreciation Expense	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	1,444	7,640
Loan Payments	2,387	2,387	2,387	2,387	2,387	2,387	2,387	2,387	2,387	2,387	2,387	2,387	28,644
Changes in Working Capital:													
Accounts Receivable	(9,360)	6,964	9,083	(18,923)	(605)	(2,574)	(7,266)	12,261	(6,207)	1,818	(13,322)	(14,928)	(43,329)
Inventories	(3,041)	7,960	1,211	(1,624)	(638)	(2,716)	(7,668)	(8,414)	(7,639)	2,235	(16,4011)	4,965	(31,771)
Accounts Payable	8,932	2,694	8,932	8,932	8,932	8,932	8,932	8,932	8,932	8,932	8,932	8,932	
Capital Expenditures	(50,000)												(50,000)
Owner Draws	(6,667)	(6,667)	(6,667)	(6,667)	(6,667)	(6,667)	(6,667)	(6,667)	(6,667)	(6,667)	(6,667)	(6,667)	(80,000)
Total Cash Adjustments	$ (56,574)	$ 14,783	$ 10,972	$ (30,704)	$ (4,312)	$ (9,121)	$ (20,581)	$ 5,755	$ (19,082)	$ 1,920	$ (43,746)	$ (12,019)	$ (162,709)
Net Cash Surplus / (Shortfall)	$ (31,710)	$ 34,150	$ 26,369	$ (4,440)	$ 11,998	$ 8,207	$ (9,110)	$ 19,352	$ (1,243)	$19,049	$ (21,086)	$ 17,089	$ 68,623
Cum. Surplus / (Shortfall)	$ (31,710)	$ 2,440	$ 28,809	$ 24,369	$ 36,366	$ 44,574	$ 35,464	$ 54,815	$ 53,572	$ 72,621	$ 51,535	$ 68,623	

Owned. Ideally, the monthly cash budget will be prepared by *department*. At the very least, every line item on the budget should be "owned" by a single individual – someone who is responsible for ensuring that the line-item in question doesn't exceed budget (and is less than budget if there's likely to be a sales shortfall during the year).

Managing Working Capital. Working Capital or, to be technically correct, Net Working Capital is simply the total of current assets (e.g., cash, A/R, inventory) less the total of current liabilities (e.g., accounts payable). It encompasses three of the eight Impact Drivers: A/R, Inventory and A/P). Working Capital is a measure of liquidity – of a firm's ability to fund current operations. If a company's "current ratio" – the ratio of current assets to current liabilities – is less than one, it's probably facing a significant cash shortfall.

As the following table demonstrates, from a liquidity perspective, Mike's appears to be in good shape:

Mike's Guitar Shop
Working Capital

	12 MONTHS ENDING 12/31/X3	12 MONTHS ENDING 12/31/X4	12 MONTHS ENDING 12/31/X5
Current Assets	$ 136,561	$ 184,918	$ 298,527
Current Liabilities	56,352	100,752	124,573
(Net) Working Capital	$ 80,209	$ 84,166	$ 173,955
Current Ratio	2.42	1.84	2.40

Although Mike's current ratio is reasonable, it's not as good as the industry average (of 2.83). So, the never-changing question is: Can he do better? Can he squeeze more cash out of the system so that he can fuel more growth or, simply, pay himself more?

To answer that question, Mike will need to review his Cash Conversion Cycle (CCC). The CCC is the number of days that pass from the time Mike starts spending money on the stuff needed to build a guitar (e.g., materials and labor) to the time he gets paid for selling that guitar.

The CCC is comprised of three distinct time periods:

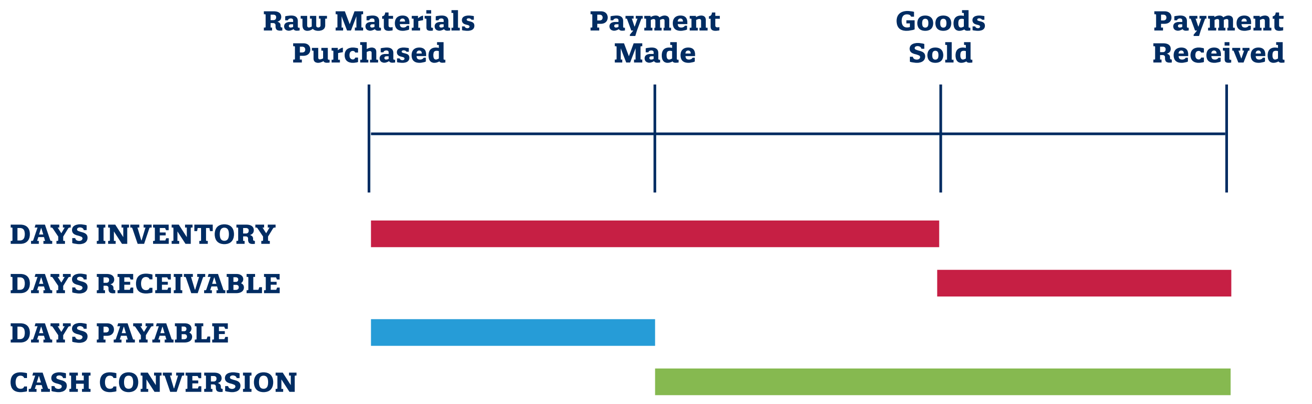
1. The **average age of inventory**, which is commonly referred to as "Days Inventory on Hand" or, simply, "Days Inventory". Days Inventory measures the average time required to convert raw materials into finished goods and then sell them.

2. The **average collection period**, which measures the average length of time it takes to collect cash following a sale and is commonly referred to as "Days Receivables"; and

3. The **average payment period**, also referred to as "Days Payables", which measures the average length of time between the purchase of materials (inventory) and the payment of cash for them.

Generally speaking, the lower the CCC the better.

THE CASH CONVERSION CYCLE

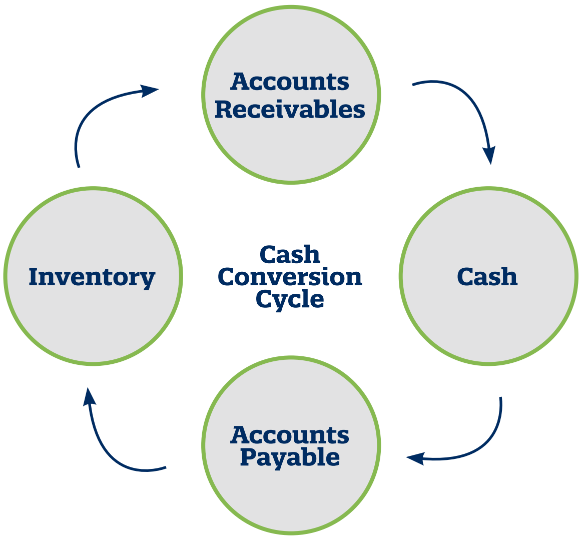


As shown below, Mike's CCC declined from 80.2 days to 78.1 days. As of 12/31/X5, the Shop had 80 days of inventory on hand (slightly worse than the industry average of 72 days), its average collection period was 52.5 days (significantly worse than the industry average of 29.4 days), and its average payment period was 54.5 days versus the industry average of 52 days.

Mike's Guitar Shop
Cash Conversion Cycle

	INDUSTRY AVERAGE	12 MONTHS ENDING 12/31/X4	12 MONTHS ENDING 12/31/X5
Days Inventory			
Ending Inventory		$ 91,954	$ 134,536
÷ Avg. Daily COGS		$ 1,000	$ 1,682
= Days Inventory on Hand	72.1	92.0	80.0
Days Receivables			
Ending Accounts Receivable		$ 91,715	$ 157,098
÷ Avg. Daily Sales		$ 1,872	$ 2,992
= Avg. Collection Period	29.4	49.0	52.5
Days Payable			
Ending Accounts Payable		$ 60,770	$ 91,569
÷ Avg. Daily COGS		$ 1,000	$ 1,682
= Avg. Payment Period	52.3	60.8	54.5
Cash Conversion Cycle			
Days Inventory (+)	72.1	92.0	80.0
Days Receivable (+)	29.4	49.0	52.2
Pays Payable (-)	(52.3)	(60.8)	(54.5)
	49.2	80.2	78.1

Based on this analysis, Mike's biggest opportunity to accelerate his cash flow appears to be in decreasing his average collection period. If his competitors are collecting their receivables in less than 30 days, there's no apparent reason that Mike's can't do the same. As of 12/31/X5, the Shop is carrying about 23 more days of receivables than his competitors (52.5 days – 29.4 days = 23.1 days). Since each day of receivables is worth $2,992 (Annual Sales ÷ 365 days), the Shop could accelerate its cash flow by more than $69,000 if it could get its Days Receivable down to the industry average ($2,992 X 23.1 days = $69,115). That's *a lot* of cash! Also, keep in mind that industry averages are just that: Averages! Which means that ½ of the companies that reported did better than the benchmark.



Of course, this begs the question: Given that Mike's terms are similar to the rest of the industry, why are its Days Receivable so much worse than average? There are many possibilities: There may be inconsistencies or mistakes in his invoices which are causing internal delays within his customers' accounting department. There may be process issues that are causing delays in mailing the invoices. Or his competitors might be offering discounts for timely payment. Whatever the cause, the solution – most often – is to simply ask for payment. Ask frequently, ask repeatedly, and start asking *before* the payment is due.

While Mike's doesn't appear to have any significant issues in the other components of working capital at *this time*, he should be monitoring all of them every day. This can be done using something called a Flash Report. The Flash Report is a daily snapshot of all receipts (receivables) and disbursements (payables), as well as a cash forecast for the next several weeks. It's a key tool in the battle to manage cash flow. Many of our clients use the following format:

Daily Flash Report

CASH AVAILABLE				
Bank Balance		$	Line of Credit Usage	
add:	Deposits in Transit	$	Borrowing Base*	$
less:	Outstanding Checks	$	Current Balance	$
General Ledger Balance		$	Available	$
Unreconciled Difference		$		
Unuused Line of Credit		$		
TOTAL CASH AVAILABLE		$		

*0.75 of under 90 day receivables.

ACCOUNTS RECEIVABLE					
	0-30	**31-60**	**61-90**	**90+**	**Total**
					$
Top Over 60 Day Accounts					
Comapny A					$
Company B					$
Company C					$
					$
					$
					$
All Others Combined					$
Total				$	$

ACCOUNTS PAYABLE					
	0-30	**31-60**	**61-90**	**90+**	**Total**
					$
Top Over 60 Day Accounts					
Dispute with Vendor A					$
					$
					$
					$
					$
					$
All Others Combined					$
Total				$	$

ACCOUNTS RECEIVABLE					
Week Ending:	**1/3/2020**	**1/10/2020**	**1/17/2020**	**1/24/2020**	**1/31/2020**
Beginning Cash Balance	$	$	$	$	$
add: Receipts					
LOC Advances					
Other					
Cash Available					
Less: Payroll & Payroll Taxes					
Employee Expense Reports					
A Vendors (Must Pay)					
B Vendors (Mission Critical)					
C Vendors (Everyone Else)					
LOC Payments					
Other					
ENDING CASH BALANCE	$	$	$	$	$

Managing Fixed Capital. The final ROIC Impact Driver is fixed capital or, more specifically, capital expenditures (CapEx). As Mike's Statement of Cash Flows demonstrates, during 20X4 the company invested $115,000 in additional equipment to support future growth. The question is: Was it worth it? Is it likely that the $115,000 will generate sufficient returns to justify the expenditure? This isn't necessarily an easy question to answer, but understanding *how* to answer it is vitally important.

Many small business owners that we work with would make this "capital budgeting" decision based on their "gut"; or they'd just do it because increasing customer demand "requires" the investment; or they might do some back-of-the-envelope analyses to determine if they could afford the new loan payment. But that would be the end of the analysis. Some will take things a step further and calculate the payback period – the time it takes for annual profits to equal the investment – and compare it to some arbitrary "rule of thumb" (as in "I only make investments that have a payback period of less than 3 years"). None of these approaches, however, address the real question: "Can Mike expect the $115,000 investment to earn a return that will fairly compensate him for the risks involved?" Or, stated another way: *Will the investment create value for the business?*

The first step in the process is to prepare an estimate of the future after-tax cash flows that are expected to result from the investment. In the following "proforma", positive numbers represent cash in-flows and negative numbers represent cash out-flows:

Proforma: Expected Results from Mike's $115,00 Investment

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Increase in:						
Sales		$ 200,000	$ 250,000	$ 300,000	$ 350,000	$ 400,000
Variable Costs		110,000	137,500	165,000	192,500	220,000
Fixed Costs		50,000	75,000	75,000	75,000	75,000
Operating Profits	$ -	$ 40,000	$ 37,500	$ 60,000	$ 82,500	$ 105,000
Proforma Taxes @ 20%		(8,000)	(7,500)	(12,000)	(16,500)	(21,000)
NOPAT	$ -	$ 32,000	$ 30,000	$ 48,000	$ 66,000	$ 84,000
Plus / (Less):						
Depreciation		7,667	7,667	7,667	7,667	7,667
Working Capital		(36,000)	(9,000)	(9,000)	(9,000)	(9,000)
Working Capital - Recovery						72,000
Capital Expenditures	(115,000)	-	-	-	-	-
FREE CASH FLOW	$ (115,000)	$ 3,667	$ 28,667	$ 46,667	$ 64,667	$ 154,667

A few things in this proforma are noteworthy:

1. The first section of the proforma is a calculation of project-specific NOPAT (the numerator of ROIC);
2. The second section of the proforma is a calculation of project-specific Invested Capital (the denominator of ROIC).
3. Working Capital represents an investment in the project, just like the initial $115,000 capital expenditure ("CapEx"). However, when the project winds down, the net investment in working capital (receivables, inventory and payables) will be recovered. While the project may be "renewed", we're assuming that the CapEx – and the additional revenue it generates – has a useful life of 5 years.
4. The resulting "Free Cash Flow" (FCF) is, basically, the amount of money that's left-over to pay either lenders (if the project was bank-financed) or investors (the owner). Note that FCF is close to, but doesn't exactly match, the first two sections of the Statement of Cash Flows. The primary difference, as noted above, is the exclusion of interest expense.

Now for the easy part: Open up MS Excel, type in the six FCF numbers from the chart above, and use the @ IRR function. IRR stands for "Internal Rate of Return" and it reflects the rate of return that a project is expected to generate during its lifetime. In this case, we get an IRR of 27.03%:

@IRR	**Year 0**	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
27.03%	$ (115,000)	$ 3,667	$ 28,667	$ 46,667	$ 64,667	$ 154,667

A project is considered to be worth pursuing if its IRR is at *least* equal to the business's minimum required rate of return ("hurdle rate"). Assuming Mike's hurdle rate is 20%, this project would be a "Go!" because the project's 27% IRR exceeds its hurdle rate. In other words, when a project's IRR is greater than its hurdle rate, the project – if all goes as planned – will create value for the company. If, on the other hand, the IRR is less than the hurdle rate, the project would decrease the value of the business and, therefore, should not be pursued (see the Appendix for a full discussion of the mathematics of value-creation).

Sensitivity Analysis. One of the benefits of building a long-term financial plan is that it allows you to easily perform "what-ifs", aka sensitivity analysis. The power of sensitivity analysis is that it can help you understand which financial variables have the most impact on your company's financial health which, in turn, can help you prioritize your cash flow improvement efforts.

Another option is to use our "Impact Driver" spreadsheet, which was inspired by Vern Harnish, the author of *The Rockefeller Habits* and *Scaling Up*. The spreadsheet allows you to very quickly and easily see the impact of incremental changes to the 8 key variables that impact Free Cash Flow.

Impact Driver Sensitivity Analysis

Instructions	Prior Year Results		Critcal Values
To start, enter yoru most recent full-year financial results in the boxes to the right, including the box labeled "Free Cash Flow". Then adjust any or all of the Impact Drivers using the arrow button or simply type a value between -10 and 10 to see the impact on cash flow. Free Cash Flow = Cash Flow from Operations minus Capital Expenditures.	Sales		
	Variable Costs		
	Gross Margin		
	Fixed Costs		
	Accounts Receivable		Days
	Inventory		Days
	Accounts Payable		Days
	Capital Expenditures		
	# of Units		Per Unit

Prior Year's Free Cash Flow $ 93,626

Impact Drivers

price inc (dec) %		%		
volume inc (dec) %		%		
variable cost dec (inc) %		%		
fixed expense dec (inc) %		%		
dec (inc) in days receivable		days		
dec (inc) in days inventory		days		
inc (dec) in days payable		days		
capital expenditure dec (inc) %		%		
TOTAL IMPACT				0.0%
PERFORMA FREE CASH FLOW			$ 93,626	

Assumptions and Items to Make it Happen!

↑ **PRICE:**

↑ **VOLUME:**

↓ **VARIABLE COST:**

↓ **FIXED EXPENSES:**

↓ **DAYS RECEIVABLE:**

↓ **DAYS INVENTORY:**

↑ **DAYS PAYABLE:**

↓ **CAPITAL EXPENDITURES:**

Calculating ROIC. If, at this point, your head is swimming or you're saying to yourself "I don't have time for all this financial mumbo jumbo", let us share with you a quote from Vern Harnish, one of the world's foremost business growth gurus: [34]

> "Businesses often under invest on the accounting side of their business, seeing it as pure overhead meant to be kept to a minimum. And given a marginal dollar, most business owners will opt to either spend it on acquiring more resources or making more sales. In fact, I've seen the best investment a company can make is bolstering the numbers side of the business. Hiring just one additional accounting clerk or a part-time CFO can double profitability and cash within twelve months."

To which we'll add: if you spend a few minutes playing with the Impact Driver Sensitivity Analysis, you'll probably identify more than enough wasted cash to pay for a good finance-geek.

But, we digress. As we noted earlier, ROIC is a key indicator of financial performance. It's about as close as we can get – by using standard financial statements and avoiding all the number-tumbling involved in discounting cash flows – to understanding whether a company is creating value. As such, to a large degree, it's the ultimate measure of whether your strategy, as reflected in your long-term plan, is *valuable*.

As you review the following calculation of ROIC, note the adjustment to Operating Income for Mike's "salary". Because Mike's Guitar Shop is an LLC, his "salary" (draw) never hits the P&L. As such, his business income is overstated, and we need to adjust for that overstatement so that we don't overstate ROIC. Also note the adjustment for "Proforma Taxes." Again, because Mike's is an LLC, his business-related income taxes never hit the P&L.

	12/31/X5 (ACTUAL)	12/31/X6 (PROJECTED)	12/31/X7 (PROJECTED)	12/31/X8 (PROJECTED)
Operating Income	$ 165,455	$ 231,332	$ 299,305	$ 424,048
Less: Owner's Draw	(60,000)	(80,000)	(100,000)	(120,000)
Adjusted Operating Income	$ 105,455	$ 151,332	$ 199,305	$ 304,048
Proforma Taxes @ 20%	(21,091)	(30,266)	(39,861)	(60,810)
NOPAT (A)	$ 84,364	$ 121,066	$ 159,444	$ 243,238
Working Capital	$ 194,959	$ 284,980	$ 426,308	$ 582,378
Less: Cash	(6,893)	(14,740)	(61,416)	(129,912)
Adjusted Working Capital	$ 188,066	$ 270,241	$ 364,892	$ 452,466
Fixed Capital	$ 163,333	$ 196,000	$ 225,333	$ 344,667
INVESTED CAPITAL (B)	$ 351,399	$ 466,241	$ 590,225	$ 797,133
ROIC (A ÷ B)	24.0%	26.0%	27.0%	30.5%

At first glance, it would appear that Mike's Guitar Shop is doing phenomenally well. Mike's ROIC is significantly higher than its hurdle rate – despite significant increases in owner draws – and it's growing. And that's the problem: Mike's ROIC is almost *too* good.

The issue is that it's rare to see small companies earn significant excess returns year after year after year. Markets are simply too competitive. So, one of two things is going on: Either Mike has absolutely nailed his strategy for the Guitar Shop and the projections are realistic, or the projected financials are overly-optimistic (i.e., sales are over-stated, costs are under-stated, or the plan doesn't include sufficient CapEx). Whatever the reason, whenever you see projected ROICs that are significantly higher than your hurdle rate, it should raise a red flag and you should carefully re-review your projections.

Mike's Guitar Shop
Income Statement - Projected

	12 MONTHS ENDING 12/31/X6		12 MONTHS ENDING 12/31/X6		12 MONTHS ENDING 12/31/X6	
Sales	$ 1,441,715	100.0%	$ 1,787,726	100.0%	$ 2,216,780	100.0%
Cost of Goods Sold	798,710	55.4%	1,027,942	57.5%	1,274,649	57.5%
Gross Profit	$ 643,005	44.6%	$ 759,784	42.5%	$ 942,132	42.5%
S,G & A Expense						
Advertising/Marketing	10,200	0.7%	10,200	0.6%	10,200	0.5%
Bank Service Charges	3,716	0.3%	3,716	0.2%	3,716	0.2%
Depreciation	17,333	1.2%	20,667	1.2%	30,667	1.4%
Insurance	5,993	0.4%	6,592	0.4%	7,252	0.3%
Internet/Web Related	1,901	0.1%	2,091	0.1%	2,300	0.1%
Meals & Entertainment	2,680	0.2%	2,680	0.1%	2,680	0.1%
Payroll	260,505	18.1%	298,530	16.7	338,457	15.3%
Payroll Taxes	24,487	1.7%	28,062	1.6%	31,815	1.4%
Professional Services	6,500	0.5%	6,500	0.4%	6,500	0.3%
Repairs & Maintenance	11,232	0.8%	9,924	0.6%	9,924	0.4%
Rent	42,000	2.9%	42,000	2.3%	42,000	1.9%
Shop Supplies	7,987	0.6%	10,279	0.6%	12,746	0.6%
Travel	4,488	0.3%	4,757	0.3%	5,043	0.2%
Utilities	11,908	0.8%	12,206	0.7%	12,511	0.6%
Other	742	0.1%	2,274	0.1%	2,274	0.1%
Total S,G & A Expense	411,673	28.6%	460,478	25.8%	518,084	23.4%
Operating Income	$ 231,332	16.0%	$ 299,305	16.7%	$ 231,332	19.1%
Other (Inc) / Exp:						
Interest Expense	7,640	0.5%	6,565	0.4%	5,437	0.2%
Miscellaneous	-	0.0%	-	0.0%	-	0.0%
Total Other	$ 7,640	0.5%	$ 6,565	0.4%	$ 5,437	0.2%
Net Income	$ 223,692	15.5%	$ 292,740	16.4%	$ 418,611	18.9%

Mike's Guitar Shop
Balance Sheet - Projected

	12 MONTHS ENDING 12/31/X6		12 MONTHS ENDING 12/31/X7		12 MONTHS ENDING 12/31/X8	
Current Assets:						
Cash	$ 14,740	2.6%	$ 61,416	8.3%	$ 129,912	12.5%
Accounts Receivable	192,558	33.8%	195,915	26.5%	242,935	23.5%
Inventory	166,307	29.2%	256,282	34.7%	317,789	30.7%
Total Current Assets	$ 373,604	65.6%	$ 513,613	69.5%	$ 690,636	66.7%
Property, Plant & Equipment						
Gross Fixed Assets	260,000	45.6%	310,000	42.0%	460,000	44.4%
Acc'd Depreciation	(64,000)	-11.2%	(84,667)	-11.5%	(115,333)	-11.1%
Net Fixed Assets	$ 196,000	34.4%	$225,333	30.5%	$ 344,667	33.3%
Total Assets	$ 569,604	100.0%	$ 738,946	100.0%	$ 1,035,303	100.0%
Current Liabilities						
Accounts Payable	88,624	15.6%	87,305	11.8%	108,258	10.5%
Line of Credit	-	0.0%	-	0.0%	-	0.0%
Current Maturities	22,079	3.9%	23,207	3.1%	24,395	2.4%
Total Current Liabilities	$ 110,703	19.4%	$ 110,512	15.0%	$ 132,653	12.8%
Long-term Liabilities	119,248	20.9%	96,041	13.0%	71,646	6.9%
Total Liabilities	$ 229,951	40.4%	$ 206,553	28.0%	$ 204,299	19.7%
Owner's Equity	339,653	59.6%	532,393	72.0%	831,004	80.3%
Total Liabilities & O.E.	$ 569,604	100.0%	$ 738,946	100.0%	$ 1,035,303	100.0%

Mike's Guitar Shop
Statement of Cash Flows - Projected

	12 MONTHS ENDING 12/31/X6	12 MONTHS ENDING 12/31/X7	12 MONTHS ENDING 12/31/X8
NET INCOME	$ 223,692	$ 292,740	$ 418,611
PLUS:			
Depreciation	17,333	20,667	30,667
Plus / (Less) Change in:			
Accounts Receivable	(35,459)	(3,357)	(47,020)
Inventory	(31,771)	(89,975)	(61,508)
Accounts Payable	(2,945)	(1,319)	20,953
Cash Flow from Operations	$ 170,851	$ 218,755	$ 361,703
Capital Expenditures	(50,000)	(50,000)	(150,000)
Proceeds from Sale	-	-	-
Cash Flow from Investments	$ (50,000)	$ (50,000)	$ (150,000)
Change in Short-term Debt	(12,000)	-	-
Change in Long-term Debt	(21,004)	(22,079)	(23,207)
Change in Capital Accounts	(80,000)	(100,000)	(120,000)
Cash Flow From Financing	$ (113,004)	$ (122,079)	$ (143,207)
Net Cash Flow	$ 7,847	$ 46,676	$ 68,496
RECONCILIATION			
Beginning Cash	$ 6,893	$ 14,740	$ 61,416
Ending Cash	$ 14,740	$ 61,416	$ 129,912
Change in Cash	$ 7,847	$ 46,676	$ 68,496
Unreconciled Difference	$ -	$ -	$ -

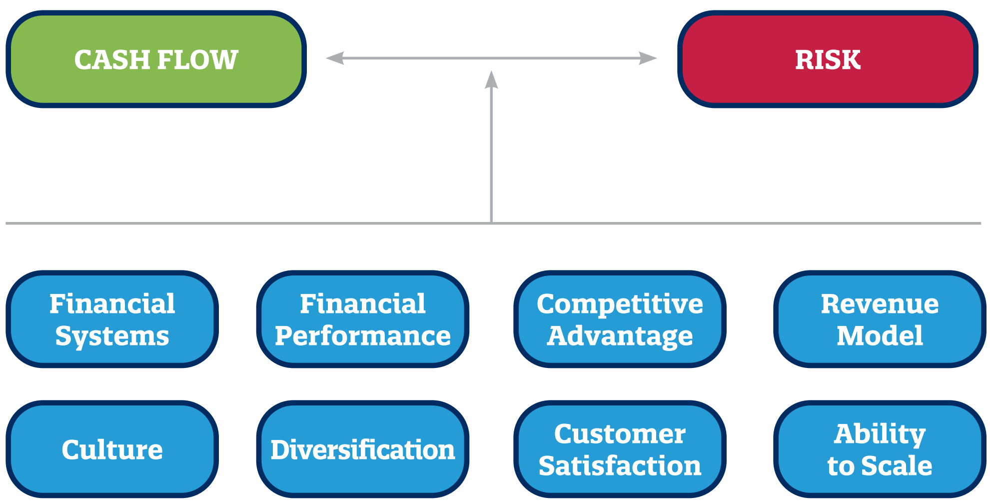
VALUE

Before we dive into the details of value, it's important to re-iterate why we're spending so much time talking about it. The reason, again, is simple: Making key business decisions with an eye toward their impact on business value helps to ensure that those decisions are the *right* decisions. This approach to decision-making is known as Value-based Management (VBM).

Fundamentally, the value of any business boils down to just two variables: *cash flow and risk*. Value is directly related to expectations about future cash flows, and inversely related to perceptions about future risks. In other words, a business's value can be increased in one of two ways: by increasing net cash flows or by decreasing the risk associated with those cash flows.

Importantly, and as we saw in the @IRR example, cash flow and risk are also the two primary variables that are at the heart of almost every business decision. Yes, business owners sometimes make decisions that are principle-based rather than value-based. And that's perfectly fine; as long as the owners are aware of how those decisions might impact cash flow (value).

VALUE DRIVERS



Value Drivers. In our view, there are 8 fundamental "Value-Drivers" – variables that impact cash flow and/or risk which, importantly, can be managed. Most of these Value-Drivers have been addressed, at least indirectly, throughout Focus Four™. But each deserves to be reiterated:

1. The Quality of your **Financial Systems**. If you don't have timely, high-quality financials, you can't make timely, high-quality financial decisions. In addition, nothing will scare off lenders (or prospective buyers) faster than loose financial records. Your tax returns need to match up with your internal financial statements, and those statements need to be supported by supplemental schedules that are verifiable. In addition, as your business grows, so should the level of assurance that you demand from your accountant. Accountants offer three levels of assurance: compilations, reviews and audits. Of the three, compilations offer the least assurance and audits offer the most assurance.

2. Historical and Prospective **Financial Performance**. If your historical financial performance has been spotty, then – unless something significant changes – it's likely that your future financial performance will also be spotty. In business, history tends to repeat itself (thus, the oft repeated phrase: "the trend is your friend"). History can give you lots of hints about where to focus your business-building efforts. In addition, if you decide to seek a large loan (or other source of external capital), the first thing that the bankers are going to look at is your historical financial performance: Sales growth, operating margins, and the components of ROIC. The second thing they're going to look at is your *prospective* financial performance and, when they do, the first thing they're going to ask themselves is whether your future plans are realistic given your historical performance and the outlook for your industry.

3. The Strength of your **Competitive Advantage**. The stronger your company's Competitive Advantage (key differentiators and Brand Promise), the faster it's likely to grow and the more profitable it's likely to be. Ideally, you'll own the majority of the market share within your geographical location or industry niche. Competitive Advantage also is enhanced by having a well-articulated Vision (the "Why") supported by the ability to consistently execute on that Vision.

4. Your company's **Revenue Model**. In an ideal world, all of your product offerings would be non-discretionary (i.e., in demand regardless of economic conditions) and sold with some kind of long-term commitment from you customers. This commitment could be contractual (e.g., your local HVAC company's annual service-contract), or subscription-based (e.g., Apple Music), or implied (e.g., the need to refill ink in your printer on a regular basis). Keurig provides a great example: Not only do its customers pay a significant premium for the convenience of fast coffee, they also lock themselves into buying Keurig's patented "K-Cup" (or, at least, they did until the patent expired). Then, they're encouraged to subscribe to regular deliveries of their favorite coffees. This model incorporates all the keys to a successful strategy: First, there's a significant barrier to entry – it's difficult for customers to justify switching to competitors' coffee-makers because of the large up-front outlay for a Keurig. Second, there's a significant differentiator (convenience) that customers are willing to pay premium prices for. And third, there's a largely non-discretionary refill component with subscription potential.

5. Your company's **Culture**. As we noted earlier, "culture eats strategy for breakfast". Why? Because without a culture of accountability – without the right people in the right seats enthusiastically rowing in the right direction – it's unlikely that you'll be able to effectively execute your strategy, no matter how good it is.

6. Your company's level of **Diversification**. We're not talking about product diversification – most small businesses are better off pursuing a highly-focused niche strategy. What we're talking about is diversification among your customers, your vendors and your employees. From a customer perspective, you don't want to be overly-dependent on just a handful of customers. Your top 5 customers should ideally represent less than 10% of your annual revenues. This ratio also applies to your Vendors. You don't want your business to be crippled if one of your vendors goes out of business or decides to compete against you. Finally, you also want to avoid employee dependency. This is accomplished via cross-training and systems/process documentation.

7. Your demonstrable level of **Customer Satisfaction**. It's important to have formal processes in place to capture customer feedback so that you're constantly confirming the quality of your customer's experience and can quickly respond to any issues that arise. Just as important is the ability to turn satisfied customers into referral sources. There are many different ways to capture Customer Satisfaction, including Net Promoter Score (NPS) and the Customer Satisfaction Survey (CSAT).

8. Your company's **Ability to Scale**. Scalability is enabled by 1) a shift in owner mentality – from working in the business to working on the business (i.e., replacing the "hub and spoke" structure with a true Leadership Team structure, and 2) documenting systems, processes and procedures – for all of the company's core activities – and ensuring they're consistently followed. Without repeatable and standardized systems and processes, growth can quickly turn into chaos rather than cash flow.

Again, refer to the Appendix for a detailed analysis of the mathematics behind valuation.

Factors That Impact Risk/Discount Rates

	FACTOR	COMMENTS
QUALITY OF FINANCIAL SYSTEMS	• Timeliness & Accuracy of Financials • Level of Assurance • Tax Adjustments	• Ready for review in 3 - 5 days? • Compilation vs. Review vs. Audit? • Documented? Excessive?
FINANCIAL PERFORMANCE (ROIC)	• Past growth in sales and profits • Projected growth in sales and profits • Capital Management	• Consistent or spotty? Versus industry? • Consistent with historical trends? • Is ROIC maximized?
COMPETITIVE ADVANTAGE	• Key Differentiators • "Sweet Spot" • Brand Promise	• At least one that's truly unique? • Energies focused on Ideal Customer? • Formalized and regularly measured?
REVENUE MODEL	• Recurring Revenue • Discretionary vs. Non-discretionary • Pricing	• Contractual? Subscription-based? • Strong demand during downturns? • Do prices reflect a Competitive Advantage?
CULTURE	• Right People • Right Seats • Employee Satisfaction	• Do employees meet the "FIT" test? • Are Roles & Responsibilities defined? • Formally and regularly measured?
DIVERSIFICATION	• Customers • Suppliers • Employees	• Does any customer represent >10% of sales? • Does any vender represent >10% of costs? • Is there over-reliance on any key employee?
CUSTOMER SATISFACTION	• Experience • Repeat Business • Willingness to Refer	• Positive customer experience? • Will customers purchase again? • Will customers refer new business?
ABILITY TO SCALE	• Leadership • Systems & Processes • Operating Systems	• "Hub and Spoke" vs. true Leadership Team. • Documented and followed by everyone? • Can the comapny consistently Execute?

This reference guide does not constitute a comprehensive list of risks. A professional valuation is strongly recommended for anyone contemplating the purchase or sale of a business.

4

Appendix

Appendix

Value 102

Bank Financing 107

About the Michigan SBDC 109

Footnotes 110

Value

Virtually all business decisions come down to just two variables: Cash Flow and Risk. In making any business decision, we're trying to decide – implicitly or explicitly – if the potential benefit (increased cash flow or reduced risk) offsets the potential cost (increased risk or reduced cash flow).

From that perspective, a business is "simply" a series of capital budgeting decisions – decisions about how and where to use a company's limited resources. And the value of a business is simply the sum total of the value of all those capital budgeting decisions. Some of those decisions are relatively small (e.g., should I invest time into learning Focus Four™?). And some of those decisions are really big (e.g., should I open up a new facility or start a new product line?). But, fundamentally, if you could add up the value of all those decisions – big and small – the result would be the value of your business.

And the reality is that you *can* add them all up: your company's ability to generate cash flow is the result of all those decisions. In other words, and to use a bit of jargon: your business's value equals the present value of the future cash flows that it's expected to generate, discounted at an appropriate discount (or "hurdle") rate (a rate that reflects the risk inherent in those future cash flows).

In order to see how this works, let's revisit Mike's $115,000 investment (aka "capital budgeting decision"). In order to determine the *value* of that decision, it's important to understand three key principles:

1. **Money has time value.** In other words, $100 received today is worth more than $100 received a year from now because the money received today can be invested to earn a return. For example, if you invested $100 in a certificate of deposit (CD) yielding 2% per year, that $100 would be worth $102 in a year ($100 X 1.02 = $102). In two years, it would be worth $104.04 ($102 X 1.02 = $104.04). In finance, we refer to today's $100 as its "present value" and next year's $102 as its "future value":

   When we calculate future values, it's called compounding:

Compounding at 2.0%

	Future Values				
Present Value	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
$ 100.00	102.00				
$ 100.00		104.04			
$ 100.00			106.12		
$ 100.00				108.24	
$ 100.00					110.41

When we work backwards and calculate present values, it's called discounting:

2. **Risk and return are related.** If you invest in the stock market, you expect to earn a higher return than you would from investing in a CD because the stock market is significantly riskier than the CD. In other words, $100 invested in the stock market is going to have a *higher expected future value* than $100 invested in a CD. If the stock market didn't offer higher *expected* returns than less risky investments, it wouldn't attract any investors. And, historically, that's exactly what we've observed: on *average*, over the past several decades, the stock market has returned about 10% per year. In other words, $100 invested in the stock market today has an expected future value (in one year) of $110. Of course, some years are (much) better than average, and some years are (much) worse than average. And that variability in possible future values is *exactly* what defines risk.

Discounting at 2.0%

	Future Values				
Present Value	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
$ 100.00 ←	102.00				
$ 100.00 ←		104.04			
$ 100.00 ←			106.12		
$ 100.00 ←				108.24	
$ 100.00 ←					110.41

3. **Small businesses are exceptionally risky endeavors.** Most small businesses don't have the access to capital or, obviously, the proven track record of larger, publicly-traded businesses. As such, any investment in them should be expected to yield a significantly higher return than less-risky alternatives (such as the stock market). In the buy/sell arena, we're seeing small businesses selling for multiples that suggest that investors are demanding rates of return that are *at least twice* the expected return on the stock market. In other words, a reasonable return expectation for many small businesses is probably in the neighborhood of 20% - 25% *per year.* Some argue that 30% is the minimum return (hurdle

rate) that small businesses should target. Regardless, note the huge impact on present values of using a 20% "discount rate" versus a 2% discount rate:

Discounting at 2.0%

	Future Values				
Present Value	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
$ 98.04	100.00				
$ 96.12		100.00			
$ 94.23			100.00		
$ 92.38				100.00	
$ 90.57					100.00

Discounting at 20.0%

	Future Values				
Present Value	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
$ 83.33	100.00				
$ 69.44		100.00			
$ 57.87			100.00		
$ 48.23				100.00	
$ 40.19					100.00

In other words, the present value (today's value) of $1 received at some future point in time is completely dependent upon the risk (as reflected in the discount rate) of actually receiving that future dollar. A CD yielding 2% that will pay you $100 in one year, is worth $98.04 in today's dollars, while an investment in a small business that is expected to pay you $100 in a year is worth only $83.33 in today's dollars because the risk is so much higher.

In Mike's case, he expected his $115,000 investment to generate the following after-tax cash flows:

And the question is: do those future expected cash flows offset the risk that's associated with the investment? When we did the IRR analysis, we determined that the answer was "Yes" – that the project was worth pursuing because its 27% IRR exceeded Mike's 20% hurdle rate. In other words, the project is expected to create value. But, the question remains: How much value?

The answer is actually pretty simple to determine. We know the two key variables – cash flow (as outline above) and risk (20%) – and we know how to discount those cash flows to determine their value in today's dollars. Then, once we've discounted them, we just need to add them all up:

Proforma: Expected Results from Mike's $115,00 Investment

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Increase in:						
Sales		$ 200,000	$ 250,000	$ 300,000	$ 350,000	$ 400,000
Variable Costs		110,000	137,500	165,000	192,500	220,000
Fixed Costs		50,000	75,000	75,000	75,000	75,000
Operating Profits	$ -	$ 40,000	$ 37,500	$ 60,000	$ 82,500	$ 105,000
Proforma Taxes @ 20%		(8,000)	(7,500)	(12,000)	(16,500)	(21,000)
NO PAT	$ -	$ 32,000	$ 30,000	$ 48,000	$ 66,000	$ 84,000
Plus / (Less):						
Depreciation		7,667	7,667	7,667	7,667	7,667
Working Capital		(36,000)	(9,000)	(9,000)	(9,000)	(9,000)
Working Capital - Recovery						72,000
Capital Expenditures	(115,000)	-	-	-	-	-
FREE CASH FLOW	$ (115,000)	$ 3,667	$ 28,667	$ 46,667	$ 64,667	$ 154,667

The result is the value in today's dollars ($143,313) of Mike's $115,000 investment; and we know that the project is expected to create value because the value of those future cash flows in today's dollars ($143,313) is greater than the than the original investment ($115,000). In other words, if this project went exactly as planned, this *capital budgeting decision* would increase the value of Mike's business by $28,313 ($143,313 - $115,000).

As we noted previously, the value of a business is "simply" the value of all of its capital budgeting decisions. In other words, a firm's ability to generate future cash flows is the result of all those capital budgeting decisions – large and small. So, if we can estimate a firm's future cash flows, we can also estimate the (present) value of those cash flows and the value of the business.

Discounting at 20.0%					
	Future Values				
Present Value	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
$ 3,056	3,667				
$ 19,908		28,667			
$ 27,006			46,667		
$ 31,186				64,667	
$ 32,222					82,667
$ 28,935					72,000
$143,313	**Sum of each year's Present Value**				

Bank Financing

Breaking the Million-dollar Barrier

Many small businesses are racing toward, or have recently broken through, the million-dollar sales barrier. With such growth comes the need for capital and, often, for the owner to make his or her first ask for a "big" bank loan. Because commercial bankers are generally far more risk-averse than small business owners, knowing *how* to make the ask is vitally important. Following are a few key considerations:

Be Prepared

Fundamentally, large loan requests are sales pitches: You have to sell your banker on your ability to repay the loan, and your banker has to sell the same thing to the bank's loan committee. The key, then, is preparation: You need to be able to demonstrate that you've thoroughly analyzed all aspects of the project you're trying to get financed.

Generally, this means developing a detailed set of financial projections, accompanied by some verbiage which convincingly describes why your project is going to be successful. I'm not talking about a 20-30 page business plan but, rather, a concise summary of 1) the details of the project you plan to pursue, 2) the reason you're confident the project will go as planned (your company's strengths) and 3) the assumptions underlying your projections. If the thought of preparing detailed projections gives you the willies, don't sweat: that's something the SBDC excels at.

The Five C's

The traditional framework for judging credit-worthiness is known as "The Five C's of Credit". You'll want to make sure that your loan request package addresses them all:

Character: Character is mostly about your credit score. Bankers want to know that you have a strong history of paying your bills in a timely manner. If you have a credit score in the low 600's, you're probably going to have a very difficult time borrowing from a traditional lender.

Capacity: Capacity reflects your company's ability to generate enough cash flow to pay back the loan. Most banks measure this with something called a "Debt Service Ratio (DSR)". The DSR is calculated by dividing EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization – by your annual Loan Payments. Depending on the bank, and assuming the SBA isn't involved (see below), you'll need a DSR of 1.20 or 1.25. In other words, the bank will want a 20% – 25% cash flow cushion above-and-beyond what's needed to repay the loan. Also note that, in most cases, the bank will be looking at a "global" DSR. A global DSR captures all your sources of cash flow, and all your debt payments, both personal and business.

Capital: Capital represents the amount of skin you have in the game – your "down payment" on the project under consideration. Most banks will want to see a cash down payment of at least 20% of the project's costs.

Conditions: Conditions encompass several factors. The first is the state of your business – whether it's faltering or thriving. The second is the state of the economy, including industry trends. The third is the planned use of the requested funds, and how well those plans integrate with the other factors.

Collateral: Banks want to know that if, for some reason, your project doesn't go as planned, they'll still get repaid. As such, they are likely going to require collateral *above and beyond* the assets that you're using the loan to purchase. Most often, this collateral will consist of a mortgage on your personal residence, as well as a personal guarantee.

Know Your Options

Oftentimes, it's impossible for a business to meet all of a commercial bank's credit requirements. They may not, for example, meet the debt coverage or capital requirements. That's where the Small Business Administration (SBA) comes into play. Given the right set of circumstances, the SBA's loan guarantee program can help borrowers obtain loans with somewhat less-restrictive requirements (e.g., capital requirements as low as 10% and/or DCR requirements as low as 1.15). In addition, if real estate is involved, the SBA offers a program that allows borrowers to lock in below-market interest rates for 10 to 25 years.

Be Patient

Despite your best efforts, your banker probably is going to end up asking a lot of questions. Be patient and do your best to provide as much information as s/he needs. Remember, your banker wants to get the deal done almost as badly as you do, but s/he needs to be able to answer the gazillion-and-one questions that s/he's going to get from the bank's loan committee.

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About Michigan's SBDC

The Michigan SBDC provides consulting, training and research to assist small business to launch, grow, transition and innovate. The Michigan Small Business Development Center (SBDC) enhances Michigan's economic wellbeing by providing consulting, training and market research for new ventures, existing small businesses and advanced technology companies.

With our headquarters at Grand Valley State University in Grand Rapids, 11 regional offices and more than 20 satellite offices, we provide entrepreneurs and business owners with convenient access to counseling and training throughout Michigan.

The Michigan SBDC is committed to foster and sustain a culture of inclusion through equitable outreach and service to Michigan's diverse business community.

We partner with some great companies and organizations that love small business as much as we do. We would especially like to say thank you and give credit to our funding stakeholders, the U.S. SBA, Michigan Economic Development Corp., and GVSU.

U.S. Small Business Administration

MICHIGAN ECONOMIC DEVELOPMENT CORPORATION

GRAND VALLEY STATE UNIVERSITY