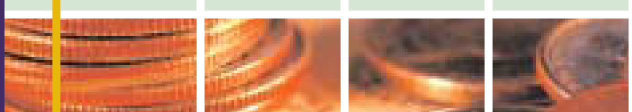
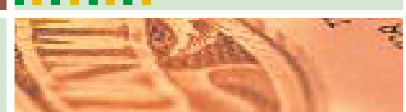
Money Matters

By Laurie Harsh

Benchmarks for Quilt Shops: Key Financial Ratios





Laurie Harsh is the founder and president of The Fabric Shop Network, Inc. Since 1997, this growing trade organization has worked to support independent quilt and fabric retailers nationwide to achieve business success. Harsh has more than 30 years of fabric-industry-specific retail management experience. She has consulted with hundreds of shops in the past six years to help them monitor and manage their business performance to reach their goals. Using financial statements and key business ratios is an essential component of her success in guiding shops in their own growth. For more information on joining the organization, go to *www.fabshopnet.com*; call Laurie Harsh at 360/892-6500; or visit FSN at Fall Quilt Market in Booth #167.

Craftrends Magazine is the leading trade magazine for quilt, sewing, and fabric retailers, providing important articles like this one every month. Retailers receive a FREE subscription. For more information, visit *www.craftrends.com* or call 303/273-1327. Reprinted with permission.

Mary's Quilt Shop
Balance Sheet

	Dec 31, 2002	Dec 31, 2001
ASSETS		
Current Assets		
Checking/Savings		
Petty Cash	$ [illegible]	
Checking	$ [illegible]	$ [illegible]
Savings	$ [illegible]	$ [illegible]
Total Checking/Savings	$ [illegible]	$ [illegible]
Other Current Assets		
Inventory	$ [illegible]	$ [illegible]
Total Other Current Assets	$ [illegible]	$ [illegible]
Total Current Assets	$ [illegible]	$ [illegible]
Fixed Assets		
Furniture and Fixtures	$ [illegible]	$ [illegible]
Less: Accumulated Depreciation	$ [illegible]	$ [illegible]
Total Fixed Assets	$ [illegible]	$ [illegible]
TOTAL ASSETS	$ 45,411.72	$ [illegible]
LIABILITIES & EQUITY		
Liabilities		
Current Liabilities		
Accounts Payable		
Accounts Payable	$ [illegible]	$ [illegible]
Total Accounts Payable	$ [illegible]	$ [illegible]
Other Current Liabilities		
Payroll Liabilities	$ [illegible]	$ [illegible]
Sales Tax Payable	$ [illegible]	$ [illegible]
Line of Credit	$ [illegible]	
Total Other Current Liabilities	$ [illegible]	$ [illegible]
Total Current Liabilities	$ [illegible]	$ [illegible]
Long Term Liabilities		
SBA Loan	$ [illegible]	$ [illegible]
Total Long Term Liabilities	$ [illegible]	$ [illegible]
Total Liabilities	$ [illegible]	$ [illegible]
Equity		
Capital Stock	$ [illegible]	$ [illegible]
Shareholders' Distribution	$ [illegible]	$ [illegible]
Retained Earnings	$ [illegible]	$ [illegible]
Net Income	$ 4,512.40	$ [illegible]
Total Equity	$ [illegible]	$ [illegible]
TOTAL LIABILITIES & EQUITY	$ 45,411.72	$ [illegible]

Mary's Quilt Shop Income Statement

	Jan - Dec 2002	% of Income
Income/Expense		
Income		
Sales	[illegible]	[illegible]
Sales Discounts	[illegible]	[illegible]
Refunds	[illegible]	[illegible]
Return Credit	[illegible]	[illegible]
Reimbursed Expenses	[illegible]	[illegible]
Total Income	[illegible]	100.0%
Cost of Goods Sold		
Cost of Goods Sold	[illegible]	[illegible]
Freight	[illegible]	[illegible]
Inventory Adjustments	[illegible]	[illegible]
Total Cost of Goods Sold	[illegible]	[illegible]
Gross Profit	[illegible]	[illegible]
Operating Expense		
Payroll Expenses	[illegible]	[illegible]
Rent	[illegible]	[illegible]
Advertising	[illegible]	[illegible]
Bad Debt	[illegible]	[illegible]
Bank Service Charges	[illegible]	[illegible]
Cash Over/Short	[illegible]	[illegible]
Continuing Education	[illegible]	[illegible]
Contributions	[illegible]	[illegible]
Dues and Subscriptions	[illegible]	[illegible]
Equipment	[illegible]	[illegible]
Equipment Rental	[illegible]	[illegible]
Insurance	[illegible]	[illegible]
Merchant Credit Card Fees	[illegible]	[illegible]
Miscellaneous	[illegible]	[illegible]
Postage and Delivery	[illegible]	[illegible]
Printing and Reproduction	[illegible]	[illegible]
Professional Fees	[illegible]	[illegible]
Repairs	[illegible]	[illegible]
Supplies	[illegible]	[illegible]
Taxes	[illegible]	[illegible]
Telephone	[illegible]	[illegible]
Travel & Ent	[illegible]	[illegible]
Utilities	[illegible]	[illegible]
Total Operating Expense	[illegible]	[illegible]
Operating Profit	[illegible]	[illegible]
Other Income/Expense		
Other Income		
Interest Income	[illegible]	[illegible]
Total Other Income	[illegible]	[illegible]
Other Expense		
Interest Expense	[illegible]	[illegible]
Depreciation Expense	[illegible]	[illegible]
Total Other Expense	[illegible]	[illegible]
Net Other Income	[illegible]	[illegible]
Net Profit Before Taxes	4,512.40	[illegible]

> "The real value of the balance sheet and income statements comes after their creation. They provide the information you need to create key business ratios that reveal the true picture of your shop's financial position."

Have you ever wondered how your quilt shop compares financially with others in the industry? Have you ever wondered what you can do to improve your shop's financial performance and outlook for the future? Using key financial and operational ratios with industry benchmarks to compare financial results can help you answer these key questions.

A three-step process makes it simple.

1. Create your shop's financial statements.

2. Analyze your shop's financial statements using key financial ratios.

3. Compare your ratios to industry benchmarks.

These steps involve some mathematical calculations that are easy to do – especially with the help of your calculator. It is a simple matter of learning how to organize your information so it provides a clear picture of where your shop stands financially from year to year and in comparison to quilt shop benchmarks (industry averages). Using benchmarks will help you obtain an objective picture of your current and historical performance so you can take charge of directing the financial destiny of your shop. And, it can be fun!

STEP 1: CREATING YOUR FINANCIAL STATEMENTS

Determining where you stand financially begins with creating your financial statements (see samples above). These include your Balance Sheet and an Income Statement (or Profit and Loss Statement). Creating these financial statements is largely a mechanical exercise. The numbers in the statements should be easily accessed in your accounting records at the end of

(more on next page)

For Example

In this shop example, note that the shop's sales were the same over the past three years, while operating expenses showed an increase in each successive year.

In other words, sales are flat and operating expenses are steadily climbing. When you compare these figures in these two areas to the industry benchmark for quilt shops, you can see that the operating expenses may be too high.

Your Company	2000	2001	2002	Industry Benchmark
Sales	$245K	$245K	$245K	
Operating Expense%	40%	42%	45%	35.5%

To improve this scenario in the coming year, you would want to reduce operating expenses and increase sales and gross profits.

"By examining the business ratios of peers or successful industry leaders, or a volume segment as a whole, you can project and plan to make adjustments so that your figures will come close to matching industry averages."

an accounting period. Then you, your accountant, or your accounting software simply has to look up the numbers and plug them into the appropriate slot in the statements.

The **Balance Sheet** is a snapshot of the financial condition of your business at a particular point in time. This snapshot shows your:

- Company's Assets – everything the shop owns
- Company's Liabilities – everything the shop owes
- Net Worth or Equity – consists of all investments made by owners into the business plus retained earnings.

The **Income Statement** shows the results of the revenue and expense activities of your shop over a period of time.

It's essential to remember that simply going through the exercise of creating and updating these two statements isn't enough. They are only the starting point for successful financial management. The real value of the balance sheet and income statements comes after their creation. They provide the information you need to create key business ratios that reveal the true picture of your shop's financial position. These ratios will help you see how your shop is doing in a number of areas. You don't have to know the exact makeup of each item on the balance sheet and income statement, but you must have a sense of what the numbers mean in order to interpret and analyze these financial records.

STEP 2: ANALYZING KEY FINANCIAL RATIOS

A **financial ratio** is a mathematical comparison between two or more items from your balance sheet or income statement.

You can use financial ratios to:

- Monitor the performance and measure the financial progress of your business
- Uncover trends
- Point to potential problem areas
- Help you with your strategic planning process

Bankers often analyze these numbers to decide if they want to lend you money and some creditors use them to determine whether or not to extend you credit.

Every business should produce an array of financial ratios that can be used for daily, weekly, or monthly monitoring to make sure all key activities are on track. When you compare changes in your business's ratios from period to period, you can pinpoint improvements in performance or developing problem areas. By comparing your ratios to those in other quilt shops with similar volume sales, you can see possibilities for improvement in key areas.

Running your quilt shop "by the numbers" isn't at all like painting by the numbers. Unlike a finished paint-by-numbers picture, financial ratios offer you several pictures, including how your shop is performing today, and how to meet business goals in the future. And, every picture tells a story about how successful a business is or could become.

There are hundreds of business ratios that can be created from your financial statements. Here are some common ones that you should be examining on a regular basis to help

(more on page 36)

you plan for and ensure your shop's success.

Analyzing Balance Sheet Ratios

There are two critical balance sheet ratios that measure liquidity and solvency (your business's ability to pay its bills as they come due) and leverage (the extent to which the business is dependent on creditors' funding).

Current Ratio: This ratio is one of the best measures of your shop's financial strength.

To calculate the Current Ratio:

$$\frac{\textbf{Total Current Assets}}{\textbf{Total Current Liabilities}}$$

The Current Ratio provides the answer to the question, "Does your business have enough current assets to meet the payment schedule of its current debts with a margin of safety for possible losses in current assets, such as inventory shrinkage?"

A generally acceptable current ratio is 2:1. The minimum acceptable current ratio is obviously 1:1, but that relationship is usually playing it too close for comfort.

Quick Ratio: This ratio is sometimes called the "acid-test" ratio and is one of the best measures of liquidity. The Quick Ratio is a much more exacting measure than the Current Ratio. By excluding inventories, it concentrates on the really liquid assets – the ones you can access quickly. It also measures the company's dependency on turning inventory to pay short-term liabilities.

To calculate the Quick Ratio:

$$\frac{\textbf{Cash + Marketable Securities + Accounts Receivable}}{\textbf{Total Current Liabilities}}$$

The Quick Ratio helps answer the question, "If all sales revenues should disappear, could my business meet its current obligations with the readily convertible funds on hand?"

A Quick Ratio of 1:1 is considered satisfactory unless the majority of your "quick assets" are in accounts receivable, and your pattern of accounts receivable collection lags behind the schedule for paying current liabilities.

Analyzing Income Statement Ratios

Income Statement Ratios measure profitability. Here are two examples.

Gross Profit (or Gross Margin) Ratio: This ratio is the percentage of sales dollars left after subtracting the cost of goods sold (COGS) from net sales. It measures the percentage of sales dollars remaining available to pay the operating (overhead) expenses of your shop.

To calculate the Gross Profit Ratio:

$$\frac{\textbf{Gross Profit}}{\textbf{Net Sales}}$$

Net Profit Margin Ratio: This ratio is the percentage of sales dollars left after subtracting the cost of goods sold (COGS) and all expenses, except income taxes. It provides a good opportunity to compare your shop's "return on sales" with the performance of other quilt shops in your industry. It is calculated before income tax because tax rates and tax liabilities vary from company to company for a wide variety of reasons, making comparisons after taxes much more difficult.

To calculate your Net Profit Margin Ratio:

$$\frac{\textbf{Net Profit Before Tax}}{\textbf{Net Sales}}$$

Analyzing Management Ratios

Other important ratios, often referred to as Management Ratios, can be derived from your balance sheet and income statement.

Inventory Turnover Ratio: This ratio reveals how well inventory is being managed. It is important because the more times inventory can be turned in a given operating cycle, the greater the profit.

To calculate your Inventory Turnover Ratio:

$$\frac{\textbf{Cost of Goods Sold}}{\textbf{Average Inventory at Cost}}$$

Return on Assets (ROA) Ratio: This measures how efficiently profits are being generated from the assets in your business when compared with the ratios of similar businesses. A low ratio in comparison with industry averages indicates an inefficient use of business assets.

To calculate your Return on Assets Ratio:

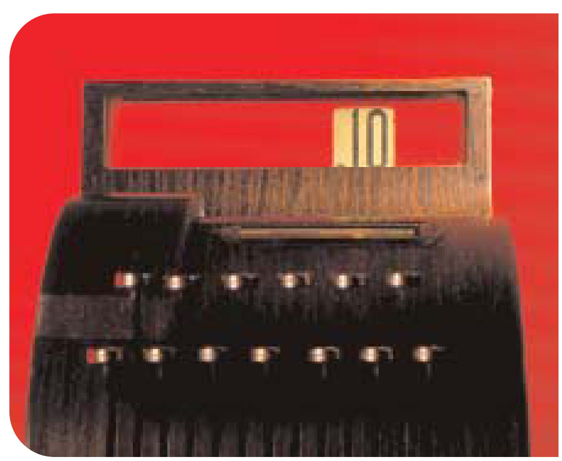
$$\frac{\textbf{Net Profit Before Taxes}}{\textbf{Total Assets}}$$

Return on Investment (ROI) Ratio: The ROI is perhaps the most important ratio of all. It is the percentage of return on funds invested in the business by its owners.

To calculate your ROI:

$$\frac{\textbf{Net Profit before Tax}}{\textbf{Net Worth}}$$

(more on page 38)



STEP 3: USING INDUSTRY BENCHMARKS

Operating and financial ratios are important in themselves, and doubly important when used to compare this year's performance with last. However, making a three-year comparison to determine trends and then comparing your ratios to industry benchmarks offers you the most opportunity to use the "numbers" in planning your financial strategies or adjusting your course.

Benchmarking is the process of continually comparing and measuring your business processes against others in the same industry. By examining the business ratios of peers or successful industry leaders, or a volume segment as a whole (for example, shops doing less than $250,000 a year in sales), you can project and plan to make adjustments so that your figures will match or come close to matching industry averages.

In addition to comparing these ratios with those of industry peers, it is important to see how your company stacks up with competitors. If a competitor is more profitable, these ratios may indicate why, and suggest areas you can address in your shop to improve your own profitability. Significant variances between your performance and industry averages could indicate an opportunity for improvement.

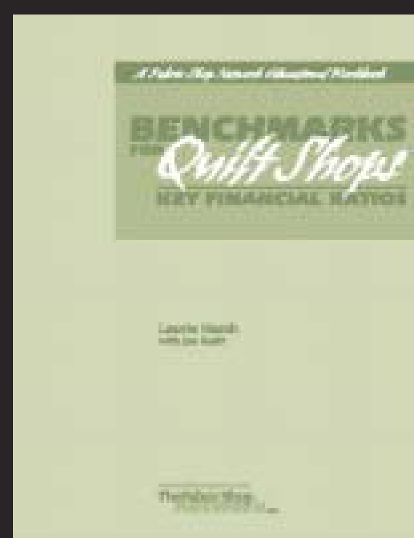
The store example on page 33 shows just one reason why it is important to create your financial statements, use them to construct key business ratios, and do the necessary benchmark comparisons to continually monitor and adjust your financial planning.

Not paying attention to these numbers is one of the key reasons small businesses fail. Using benchmarks takes discipline, but employing this process and making it a routine part of your business management practice is one of the surest ways for you to determine what's really happening financially in your shop, to adjust your course when necessary, and to make sound strategic plans for the future. ◆

More Help in New Book

Here are just a few of the many ratios discussed in the new education workbook, *Benchmarks for Quilt Shops: Key Financial Ratios*, from The Fabric Shop Network, Inc.

- Advertising as a Percent to Net Sales
- Average Sales Transaction
- Cost of Goods Sold
- Gross Sales per Square Foot
- Net Sales per Employee
- Operating Expenses
- Payroll as a Percent to Net Sales
- Rent as Percent to Net Sales



You also will find:

- Essential information and worksheets you need to learn how to construct key operational and financial ratios. These are the ratios you need to make year-to-year comparisons with your own numbers and industry averages.
- Industry benchmarks for key operational and financial ratios by volume segment. You need this information so you can compare your numbers to the segment most like your shop.
- Instruction on how to interpret your ratios so you can determine when it's necessary to adjust your business strategies to achieve your business goals.

The Fabric Shop Network workbook, *Benchmarks for Quilt Shops: Key Financial Ratios*, will be available at *www.fabshopnet.com*. ❐