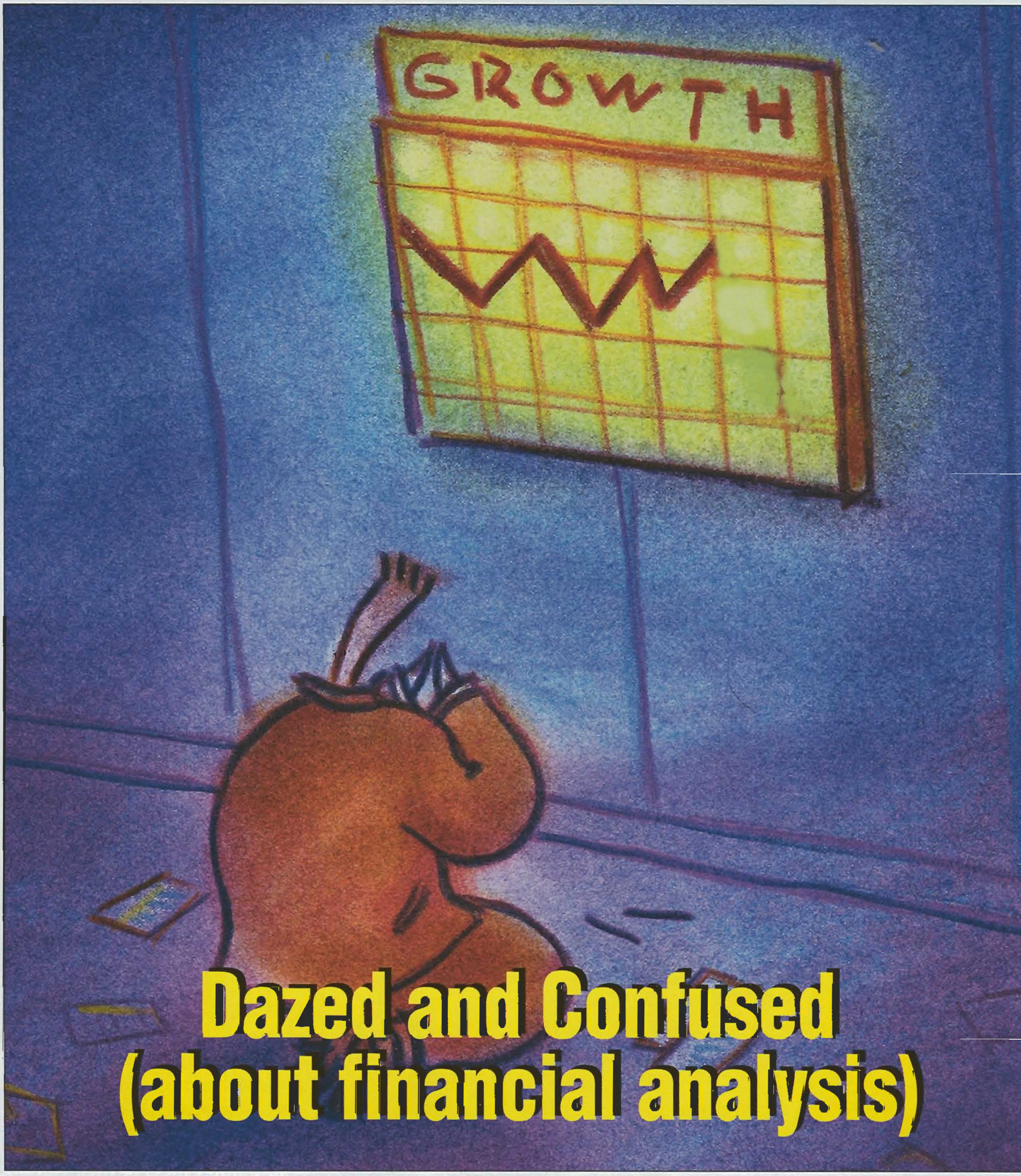
by Alan Friedman



Dazed and Confused (about financial analysis)

"Good times, bad times, you know I've had my share, but when I can't pay my monthly bills, no one else is gonna care."

That was a loose interpretation of the Jimmy Page/Robert Plant tune, and a cheap excuse to exploit the song titles of one of my favorite bands. And now, here's a joke in the same vein:

Q: So what do music retailers and Led Zeppelin have in common?

A: Dancing days appear to be over the hills and far away.

Our softening economy and the financial impact of recent national tragedies are causing many music retailers to frantically ask themselves what to do next. Get aggressive? Be conservative? Cut back? Spend more? Incur less? Borrow, merge, sell out? Or just ramble on? Retailers are feeling like they've been trampled under foot, leaving them dazed and confused on the gallow's pole to fight the battle of evermore, just waiting around like a fool in the rain for when the levee breaks.

But before you sell your music house of the holy, ask yourself if you're partly to blame for any part of these financial problems. If you're honest with yourself, you might conclude "it's nobody fault but mine." (Hey Zep fans, how am I doing so far? 12, count 'em 12!)

No Quarter, Nickels, Dollars

Whenever cash flow becomes an issue, retailers start slashing vital costs like payroll, advertising, professional fees and technology costs. How stupid. We all know that quality people "make" a store, and quality people cost more. When consumer confidence goes in the toilet, it's more (or at least better) advertising that's called for, not less. Assistance in resolving financial problems beyond your formal training can only be obtained by spending money on professional fees. And new technology is often the best place to gain operational efficiencies, thereby saving money in the long-run. So where do you get the cash to pay for these vital costs? Hey man, just look out on your floor and what do you see?

Physical (Inventory) Graffiti

Yes, your music store is littered with that physical graffiti known as "inventory." Yet again, NAMM's *Cost of Doing Business Report*—the industry's most useful guide illustrating how we do business—keeps reporting inventory turns of 1.7 times a year. In layman's terms, the average retailer has about eight months worth of inventory on hand at any time during the year. And if that's the average, you know there's product that's been hanging around for years.

But the bad news doesn't end with too many dollars tied up in inventory. Worse is the small amount of profit earned on the vast amount of inventory purchased by most music retailers. And worst of all, many retailers haven't a clue how to measure the problem, or how to fix it once they discover how big it is.

Communication Breakdown

Because most music store owners haven't been schooled in accounting, they have a limited understanding of how to compile and interpret the kind of financial analysis needed to manage their business effectively. Even if they're getting quarterly or annual financial statements from their accountant, it's not enough. They don't know which departments, products or product lines truly make them money, or are sucking the lifeblood out of their cash flow and profitability. What every music retailer needs is a simple, one-page summary that can tell them what the hell is going on with their business from a sales, profitability and inventory management standpoint.

Guess what? It already exists. "Ayeeeahhhhahhh!! I come from the land of ice and snow, where inventory sells and there's positive cash flow" (as sung by the Led Zeppelin-tribute band of CPAs, "Led Pencil").

The Crunge of the Numbers

Over the years, accountants and financial gurus have developed a systematic and ingenious way of arranging and comparing financial data that speaks volumes about how a particular business is doing. Specifically, when periodic sales, cost of sales and inventory data is compiled by product group, a report can be generated that illustrates which product groups (a) are profitable and by how much; (b) are turning inventory into cash and how quickly; and (c) are producing enough profit dollars for the dollars invested in them. And yes, the same analysis can be done by department, vendor and/or product, as long as sales, cost of sales and inventory dollars can be reported by department, vendor and/or product.

The chart on page 28 is a sample of such a report. This one-page summary is a complete sales, profitability and inventory analysis for the most recent year of Bonzo's Candy Store Rock, a music store located a misty mountain hop over the ocean to the black mountain side (just a couple more Zep references for your reading pleasure).

Whole Lotta Love for this Report

I love this report because it's easy to read and easy to produce on a Microsoft Excel spreadsheet. All you need is "sales," "cost of goods sold" and "inventory" data—by product grouping—for the period you want to measure. Your accounting software should be able to capture and report this data each and every month. (If not, change accounting software now!)

To provide a meaningful explanation of the data on this report, I've first identified how each column is calculated. For example, "gross profit" (column C) is calculated by subtracting "cost of goods sold" (column B) from "sales" (column A). Now that you know how to create the spreadsheet, let's look at what the spreadsheet is saying about Bonzo's Candy Store Rock.

What Is & What Should Never Be

The following is an explanation of each column in the report, and what it's telling us about Bonzo's business:

A. Sales: This column represents the gross annual sales for each product group. It is derived from Bonzo's accounting system.

B. Cost of Goods Sold: This column represents the annual cost of goods sold for each product group. It, too, is derived from Bonzo's accounting system.

C. Gross Profit ($): This column represents the annual gross profit dollars generated by each product group. It tells you what product groups are being sold profitably and by how much. If you immediately recognized that "Pianos and Organs" are generating the most gross profit dollars for Bonzo, you are absolutely correct. If you then concluded "Pianos and Organs" are the best products for Bonzo to invest in, you are absolutely incorrect. I'll tell you why in a minute—keep reading.

A. Gross Profit (%): This column illustrates the annual gross profit dollars generated by each department as a percent of sales. Here is where you'll see results vary greatly, depending on the type

BONZO'S CANDY STORE ROCK
ANALYSIS OF SALES and INVENTORY
"FOR THE YEAR ENDED DECEMBER 31, 2001"

	A	B	C (A - B)	D (C / A)	E	F (B /E)	G (A / Total A)	H (E / Total E)	I (C / E)
	Sales	Cost of Goods Sold	Gross Profit ($)	Gross Profit ($)	12/31/01 Inventory	Inv Turns	Sales as % of Total Sales	Inventory as % of Total Inventory	(GMROI) Gross Margin Return on Inv.
Guitars - electric	$ 300,000	$ 235,000	$ 65,000	22%	$ 330,000	0.71	13%	19%	$ 0.20
Guitars - acoustic	60,000	31,000	29,000	48%	40,000	0.78	3%	2%	$ 0.73
Basses	100,000	67,000	33,000	33%	40,000	1.68	4%	2%	$ 0.83
Amps	150,000	110,000	40,000	27%	105,000	1.05	6%	6%	$ 0.38
Drums and percussion	150,000	115,000	35,000	23%	110,000	1.05	6%	6%	$ 0.32
Keyboards	300,000	213,000	87,000	29%	190,000	1.12	13%	11%	$ 0.46
Pianos and Organs	425,000	240,000	185,000	44%	600,000	0.40	18%	35%	$ 0.31
Band and orchestra instruments	100,000	75,000	25,000	25%	55,000	1.36	4%	3%	$ 0.45
Recording equipment	275,000	200,000	75,000	27%	105,000	1.90	11%	6%	$ 0.71
Microphones	50,000	35,000	15,000	30%	10,000	3.50	2%	1%	$ 1.50
Sound reinforcement	175,000	95,000	80,000	46%	15,000	6.33	7%	1%	$ 5.33
Effects	75,000	55,000	20,000	27%	25,000	2.20	3%	1%	$ 0.80
Print Music	110,000	65,000	45,000	41%	55,000	1.18	5%	3%	$ 0.82
Accessories	130,000	70,000	60,000	46%	30,000	2.33	5%	2%	$ 2.00
TOTALS	**$2,400,000**	**$1,606,000**	**$794,000**	**33.1%**	**$1,710,000**	**0.94**			**$ 0.46**

of store you run and product you sell. Used gear has historically produced 40- to 70-percent gross profit, pianos have historically produced 38- to 50-percent, accessories have historically produced 35- to 45-percent and combo/pro audio product have historically produced 25- to 38-percent. I keep using the word historically because the continued downward trend in gross profit (due to stiff competition, the internet and mail order) has made these higher profit margins ancient history for many music retailers.

Yes, Bonzo's acoustic guitar department is producing 48 percent—big deal. It's only yielding $29,000 of gross profit. This may be due to salespeople holding out for their selling price or gross profit "percent" at the expense of making gross profit "dollars." Who cares how much sales you did, or what margin you achieved—remember, the name of the game in retailing is "gross profit dollars," not gross sales or gross profit percent!

E. Inventory: This column reports, again from your accounting system, the amount of inventory, at cost, at the end of the year. Ideally, you should use a "12-month average" inventory amount in your calculations, as it's more representative of the true inventory level throughout the year. But if that's not available or is too difficult to calculate, just use the year-end amount (from your physical count of inventory, of course).

F. Inventory Turns: This column reports the number of times inventory is sold or "turned" during the year. Here is where music retailers fall flat on their face, as inventory should be turning 3 to 4 times a year instead of the recurring industry average of 1.7. Perform this calculation and you'll see why you have no cash. You're tying up too much cash in inventory for too long a period of time. This forces you to borrow money, pay interest, miss vendor discounts and sweat it out payroll to payroll.

Looking at the report, sound reinforcement is Bonzo's only product group that's turning inventory. It's probably because he special orders P.A. gear that gets installed a few days after it arrives at the store. Accordingly, the inventory never hangs around long enough to degrade inventory turns.

G. & H. Sales vs. Inventory Analysis: These two columns show sales as a percent of total sales, and corresponding inventory as a percent of total inventory for each product group. Comparing these figures, Bonzo should be asking himself why electric guitars are 19 percent of his inventory when they're only 13 percent of his sales, or why piano and organ inventory is "twice" as much as its sales. Clearly, accessories are suffering from too little inventory because too much inventory is elsewhere.

I. Gross Margin Return on Inventory Investment (GMROI): Ah yes, the ultimate financial indicator that illustrates how many dollars of profit are earned for every dollar invested in inventory. It is the single-most important ratio that measures the "combined" affect of gross profit percent and inventory turns.

Every retailer should be attaining at least $1.50 of GMROI, with a goal of $2 or better. Bonzo is failing miserably, with only sound reinforcement and accessories meeting these goals. Look at how pitiful GMROI is for pianos and organs ($0.31). Pianos and organs is the worst performing product group, when you compare how much profit is being produced ($185,000) against how much has been invested in inventory ($600,000).

Stairway to NAMM U.

In next month's Think Tank, I'm going to talk about our industry's "new and improved" *Cost of Doing Business Survey & Report*. That article, coupled with this one, will provide you with greater insight in understanding why sales, cost of goods sold and inventory data—by product group—is vital to the financial management of every music store.

And if you're going to California for the upcoming 2002 NAMM Show, be sure to attend NAMM University's full-day "Retail Survival School" program on Monday, Jan. 21. It will cover virtually every financial aspect of running a successful music store in this highly competitive marketplace.

Some Final Thoughts While Having Tea for One in the Evening

Keep in mind that financial analysis is just a starting point. Numbers alone aren't good enough—you have to dig for the reason behind any numbers that seem out of whack.

For instance, if your analysis shows a low gross profit percent, it could mean that you're successfully blowing out old inventory and aggressively generating cash (which is good), or it could mean that you're simply selling stuff for too little (which is bad). The key is to use your analysis to spot trends and anomalies; then follow these up with further investigation.

I hope this article isn't a heartbreaker and leaves you with hots on for nowhere. Instead, I want to hear you say "Thank you, Alan. You shook me out of the red into a black dog." And how many more times will you hear Led Zeppelin puns? I don't know 'cause I can't quit you baby.

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