NCPA
NATIONAL COMMUNITY PHARMACISTS ASSOCIATION

2015 Annual Convention

Date:	Monday, October 12, 2015
Time:	8:00 am – 9:30 am
Location:	Gaylord National Harbor Resort and Convention Center, National Harbor 11
Title:	Profit Mastery: It's All About Gross Margin — the Primary Controllable Profit Drivers Sponsored by PCCA ACPE # 207-000-15-115-L04-P · 0.15 CEUs ACPE # 207-000-15-115-L04-T
Activity Type:	Application-based
Speaker:	Steve LeFever, MBA, CFE, Chairman and Founder, Business Resource Services

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Pharmacist and Pharmacy Technician Learning Objectives:
Upon completion of this activity, participants will be able to:
1. Apply gross margin drivers to your pharmacy financial information.
2. Calculate the effects of different management decisions on gross margin.
3. Relate gross profit roadmap to your pharmacy's financial management.

Disclosures:
Steve LeFever is the Chairman and Founder of Business Resources Services. The conflict of interest is resolved by peer review of the slide content.

NCPA's education staff declares no conflicts of interest or financial interest in any product or service mentioned in this program, including grants, employment, gifts, stock holdings, and honoraria.

ACPE

NCPA is accredited by the Accreditation Council for Pharmacy Education as a provider of continuing pharmacy education. This program is accredited by NCPA for 0.15 CEUs (1.5 contact hours) of continuing education credit.

PROFIT MASTERY:

It's All About Gross Margin - the Primary Controllable Profit Drivers

Washington, DC
October 12, 2015
8:00 am - 9:30 am

Program Sponsored by
PCCA

by
Steve LeFever
Chairman
Business Resource Services, Inc.

Business Resource Services Inc.
Phone 1-800-488-3520 · Seattle, WA

Statements and Ratio Analysis

DEFINITION**.....**Financial position refers to the economic condition of your business in comparison to its own past performance and to other companies of similar size.

REVIEW**.....**Section One reviewed the basic legal and tax issues affecting all businesses. The information in this section actually provides the means for a critical analysis of management roles and business organization in relation to both tax and non-tax issues.

IMPACT **.....**Determining your financial position is crucial to "fine tuning" your management decisions. It provides the level of detail a business owner needs to make sound choices.

RESULTS**.....**The information derived from financial position calculations lets you focus your attention on the ***causes*** of your business' financial strengths and weaknesses. With this information you can take positive action to ***keep*** what is working and to ***improve*** what isn't.

The Goal:

Determining your solvency, risk, and efficiency

The Tools:

Statement Spread Sheets
Financial Management Ratios
Cause and Effect "Road Map"

Key Terms

Assets ..... Everything that the business owns — including such items as cash, inventory, prepaid expenses, and vehicles.

Balance Sheet ..... A statement of financial position that shows the assets, liabilities and net worth of the business.

Current Assets ..... What the business owns that's expected to be turned into cash within one year — such as accounts receivable and inventory.

Liabilities ..... What the business owes to creditors — to the people who supply funds that must be repaid. ***Debt*** is another term for ***liability***.

Current Liabilities ..... Obligations that are due to be repaid within one year.

Long-Term Debt ..... Obligations that are scheduled to be repaid in a period greater than one year.

Net Worth ..... What the business owes to the owners — the investment that the owners have in the company. Also called ***owners' equity.***

Retained Earnings ..... The net profits (positive or negative) from the income statement that are left to accumulate in the business.

Leverage ..... The increased rate of return that is made on net worth by using debt to acquire assets.

Income Statement ..... The summary of the revenues, costs and expenses of a company that are recognized during an accounting period.

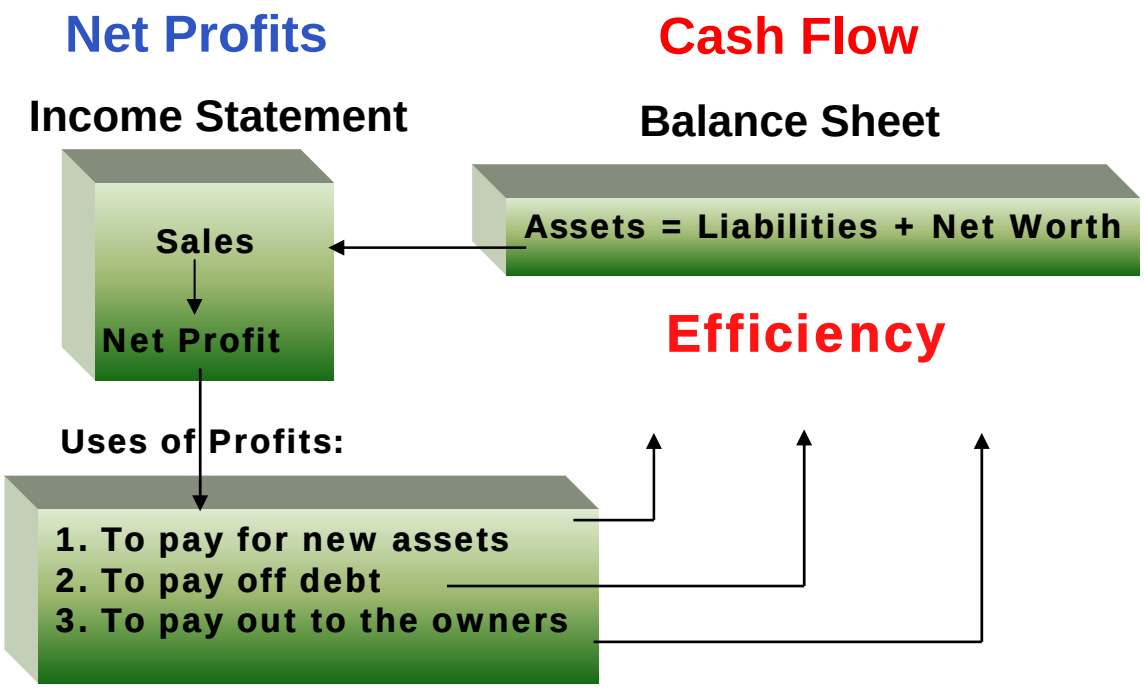
Gross Profit ..... Sales minus the Cost of Goods Sold, which is the cost of buying raw materials and producing finished goods.

Net Profit ..... The amount remaining after all expenses have been met. The difference between total sales and total costs and expenses.

Seven Steps to Business Success

1. Plan Properly before start up
2. Monitor financial position
3. Understand the relationship between price, volume, and costs
4. Manage Cash Flow
5. Manage Growth
6. Borrow Properly
7. Plan for transition

Financial Operating Cycle



Case Study
Lake's Pharmacy

Brad and René Lake's Pharmacy originally opened in 1997 in a small town just outside of a large metro area. (They had both worked for a family owned pharmacy for 10 years.)

The new business was a gradual success based on the strength of Brad and René's experience and their desire to provide a full service pharmacy.

Both of them enjoyed the great growth in their community as the metropolitan area expanded into their community. Last year, they began to plan an expansion of their location, with a section of the new facility set aside for cognitive and disease state management services. This year, they opened the enlarged store and increased the hours of operations from 55 hours per week to 58 hours per week. They also invested $50,000 to help pay for the leasehold improvements. Brad and René have increased their participation in third-party prescriptions from 50% to 83% over the three years as a way to attract more business to their improved location.

It's now the end of their fiscal year, and they have come to you for financial assistance. They are flushed with excitement, telling you things will be great if they can just get the funds they need to get "over the hump." They brush off any talk of problems as "only temporary."

What observations can you offer?

ACTION STEPS:

Step 1. Gather accurate financial information.

Step 2. Package the information so you can see relationships.

Step 3. Calculate financial ratios.

Step 4. Record your industry composites (if available).

Step 5. Compare your results.

Step 6. Analyze the possible causes of problems.

Step 7. Take action — formulate a plan, implement it, and monitor the results.

Lake's Pharmacy
Balance Sheet Spreadsheet
as of December 31

	Year 1	Year 2	Year 3	Trends
Credit Sales as a %age of Total Sales:	*41%*	*49%*	*69%*	
ASSETS				
Cash	100,400	87,900	17,100	
Accounts Receivable	71,300	100,100	223,700	
Inventory	128,200	152,600	308,600	
Other — A/R officer				
Prepaid	10,100	10,000	25,000	
Total Current Assets	**310,000**	**350,600**	**574,400**	
Equipment & Fixtures	110,000	110,000	244,000	
Leasehold Improvements	15,000	15,000	119,000	
Vehicles	26,000	26,000	26,000	
Accumulated Depreciation	(97,300)	(105,800)	(133,300)	
Fixed Assets (net)	**53,700**	**45,200**	**255,700**	
Intangible Assets				
Total Assets	**363,700**	**395,800**	**830,100**	
LIABILITIES & NET WORTH				
Notes Payable — bank			201,200	
Current Portion — long-term debt	10,000	10,000	20,000	
Accounts Payable — trade	123,200	120,000	252,000	
Accruals	28,800	30,700	55,700	
Other				
Total Current Liabilities	**162,000**	**160,700**	**528,900**	
Long Term Debt				
Notes Payable – Shareholder	20,000	10,000	50,000	
Other				
Total Long Term Liabilities	**20,000**	**10,000**	**50,000**	
Total Liabilities	**182,000**	**170,700**	**578,900**	
Capital Stock	30,000	30,000	30,000	
Additional Paid-In Capital				
Retained Earnings	151,700	195,100	221,500	
Net Worth	**181,700**	**225,100**	**251,200**	
Total Liabilities and Net Worth	**363,700**	**395,800**	**830,100**	

Lake's Pharmacy
Income Statement Spreadsheet
for the 12 months ending December 31

	Year 1	Year 2	Year 3	Trends
Square Footage	*1700sq'*	*1700sq'*	*3000sq'*	
Sales				
Prescriptions	1,377,000	1,558,000	2,614,500	
Other Sales	323,000	342,000	535,500	
Total Sales	**1,700,000**	**1,900,000**	**3,150,000**	
Cost of Goods Sold	1,261,400	1,451,600	2,545,200	
Gross Profit	**438,600**	**448,400**	**604,800**	
Expenses				
Owner's Compensation	95,000	95,000	90,000	
Salaries and Wages	134,500	148,800	231,000	
Payroll Taxes & Benefits	26,600	28,900	45,000	
Rent	26,000	26,000	40,000	
Utilities	8,500	8,600	12,500	
Prescription Containers	5,000	5,700	7,500	
Telephone	5,500	5,800	8,300	
Delivery Expenses	5,100	5,600	8,000	
Repairs and Maintenance	1,600	1,700	3,500	
Auto Expenses	1,700	1,900	2,300	
Travel & Schools	2,800	4,800	3,900	
Computer Expenses	3,200	3,900	8,000	
Postage	3,300	4,000	6,100	
Bank Fees	2,500	3,100	4,100	
Advertising	12,200	13,500	23,000	
Professional Services	4,600	7,500	7,700	
Office Supplies & Expenses	8,700	9,400	11,200	
Insurance	8,500	8,900	17,000	
Bad debts	800	600	200	
Depreciation	8,500	8,500	27,500	
Other	3,750	1,100	1,400	
Total Expenses	**367,350**	**393,300**	**558,200**	
Operating Profit	**70,250**	**55,100**	**46,600**	
Interest	2,250	3,900	15,000	
Other Income				
Net Profit Before Taxes	**68,000**	**51,200**	**31,100**	
Tax	12,000	7,800	4,700	
Net Profit After Tax	**56,000**	**43,400**	**26,400**	
FTE Employees	*5*	*5.5*	*8*	

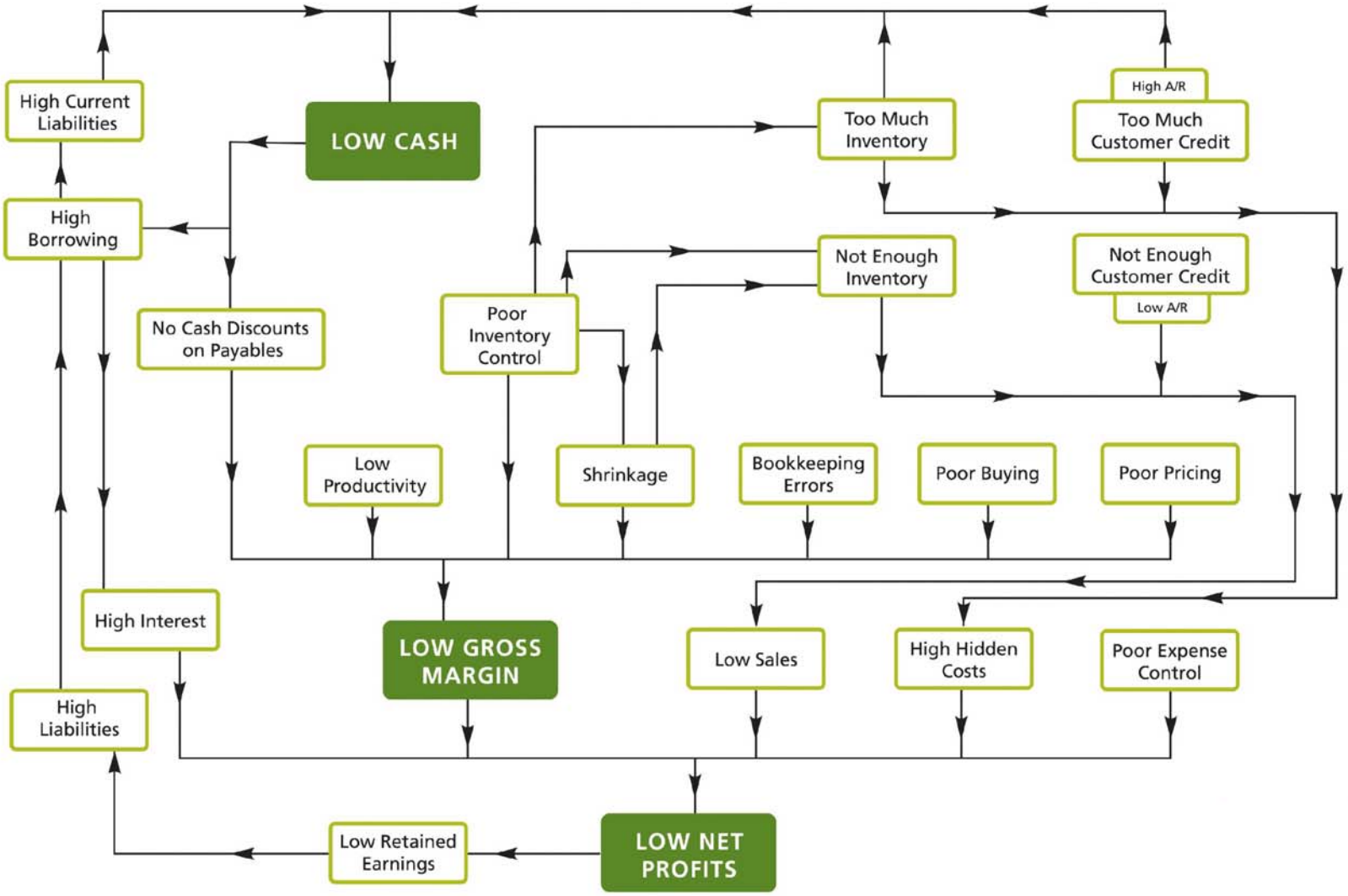
Lake's Pharmacy
Ratio Analysis Spreadsheet

			Year 1	Year 2	Year 3	Industry Composite RMA*	Calculations, Trends, or Observations
BALANCE SHEET RATIOS: Stability (or "Staying Power")							
1.	**Current**	Current Assets / Current Liabilities	1.91	2.18		3.6	
2.	**Quick**	Cash + Accts. Rec. / Current Liabilities	1.06	1.17		1.55	
3.	**Debt-to-Worth**	Total Liabilities / Net Worth	1.00	.76		0.48	
INCOME STATEMENT RATIOS: Profitability (or "Earning Power")							
4.	**Gross Margin**	Gross Profit / Sales	25.8%	23.6%		23.2%	
5	**Net Margin**	Net Profit Before Tax / Sales	4.0%	2.7%		2.7%	
PRODUCTIVITY RATIOS:							
6.	**Sales per Employee**	Sales / Total Employees	$283M	$271M		$447K	
7.	**Sales per Sq. Foot**	Sales / Square Feet	$1,000	$1,118		$1,161	
ASSET MANAGEMENT RATIOS: Overall Efficiency Ratios							
8.	**Sales-to-Assets**	Sales / Total Assets	4.67	4.80		5.47	
9.	**Return on Assets**	Net Profit Before Tax / Total Assets	18.7%	12.9%		12.56%	
10.	**Return on Investment**	Net Profit Before Tax / Net Worth	37.4%	22.8%		23%	
11.	**GMROI**	Gross Profit $'s / Inventory	3.42	2.94		3.27	
ASSET MANAGEMENT RATIOS: Working Capital Cycle Ratios							
12.	**Inventory Turnover**	Cost of Goods Sold / Inventory	9.8	9.5		10.4	
13.	**Inventory Turn-Days**	365 / Inventory Turnover	37	38		35	
14.	**Accounts Receivable Turnover**	Credit Sales / Accounts Receivable	9.8	9.3		24.3	
15.	**Accounts Receivable Turn-Days**	365 / Accts. Rec. Turnover	37	39		15	
16.	**Accounts Payable Turnover**	Cost of Goods Sold / Accounts Payable	10.2	12.1		24.3	
17.	**Average Payment Period-Days**	365 / Accts. Pay. Turnover	36	30		15	

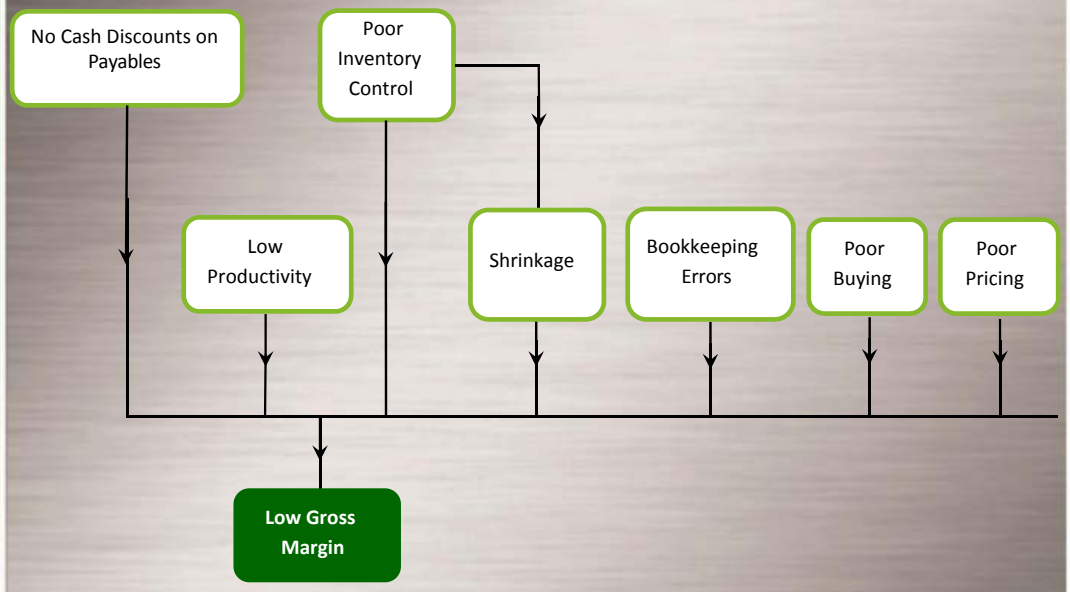
All values from 2009 NCPA Digest

The Road Map

Cause-and-effect relationships leading to financial distress.



Low Gross Margin (Ratio #4)



Low Gross Margin (Ratio #4)

What's their Low Gross Margin costing?

Their Peers' Margin: 23.2%

Their Margin in Year 3: 19.2%

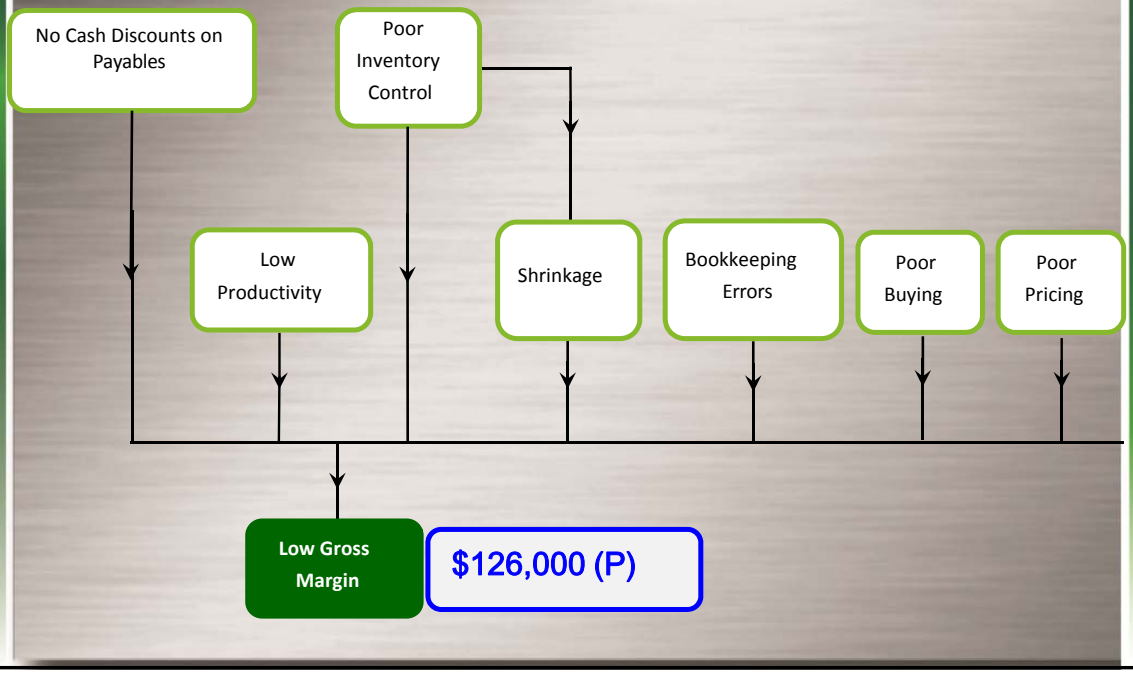
Difference 4%

Sales in Year 3: ~ $3,150,000 X
margin difference: ~ X .04

Margin $ Left on the Table: *$126,000*

Primary Impact: Profit

Low Gross Margin (Ratio #4)



Employee Productivity

- Peers achieve $447,000 in sales/employee
- $3,150,000 / $447,000 = 7 employees (target)
- S t a f f costs = $90,000 + $231,000 + $45,000 = $366,000
- $366,000 / 8 staff = ~$45,000 per employee
- Therefore, a reduction to target (7) would save$45,000

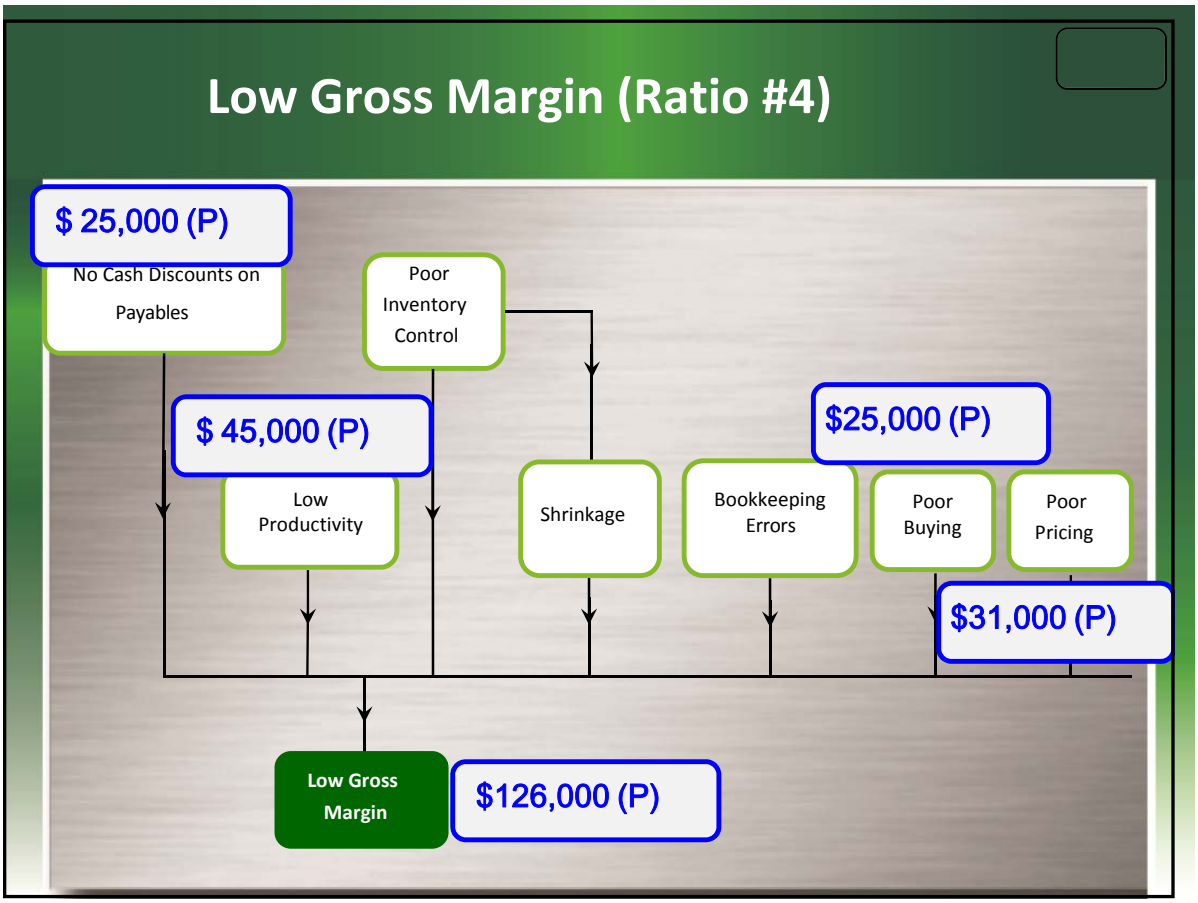
Discounts on Payables

- His current cash position does not allow them to take these discounts
- COGS ~ $2,500,000
- If they take discounts on 50% of this and the discount offered it 2% …

$1,250,000 x .02 = $25,000 in missed discounts

Poor buying and poor pricing

- If he can manage just a 1% improvement in each of these areas:
  - Buying: 1% x $2,500,000 = $25,000
  - Pricing: 1% x $3,150,000 ~ $31,000



Other Considerations

- Inventory
- A/R
- Hidden Costs
- Proper Financing

Mark-Up Versus Margin:
Clarifying the Issue

There are many people who believe mark-up and margin are the same thing — and *sometimes* they are. But generally they're not. The issue is how to arrive at a target selling price when you know the cost. The important concern here is the amount of gross profit dollars contributed from sales to cover general overhead.

Here's a simple example to illustrate the point:

Item selling price: $ 1.50

Item cost: $ 1.00

Does this price-cost relationship represent 50% mark-up or 33% mark-up?

Regardless of your answer, we can safely say that this example represents a **gross profit margin** of 33%. The standard income statement format gives us the following:

$$\text{Gross Profit Margin (GPM)} = \frac{\text{Gross Profit Dollars}}{\text{Total Sales}}$$

Since:

Total Sales	$1.50
– Cost of Goods Sold	1.00
Gross Profit	.50

$$\text{Gross Profit Margin \%} = \frac{.50}{1.50} = .33 = 33\tfrac{1}{3}\%$$

The Real Question Is: what mark-up does this represent? Or, stated another way, how much do you have to mark up a product over cost to produce a $33^1/_3$% gross profit margin? The answer here depends on how you define mark-up. Here are the <u>two</u> possible definitions:

Definition A (the common definition):

$$\textbf{Mark-Up} = \frac{\textbf{Selling Price} - \textbf{Cost}}{\textbf{Cost}}$$

$$= \frac{\textbf{1.50} - \textbf{1.00}}{\textbf{1.00}}$$

$$= \textbf{50\%}$$

Definition B (as defined by retailers):

$$\textbf{Mark-Up} = \frac{\textbf{Selling Price} - \textbf{Cost}}{\textbf{Selling Price}}$$

$$= \frac{\textbf{1.50} - \textbf{1.00}}{\textbf{1.50}}$$

$$= \textbf{33}^{\textbf{1}}/_{\textbf{3}}\textbf{\%}$$

It's important to note that *either* definition of mark-up leads to a $33^1/_3$% gross profit margin. Using the more conventional definition, it requires a 50% mark-up to produce a $33^1/_3$% gross profit margin, but retailers would say it requires a $33^1/_3$% mark-up. In other words, mark-up and margin are the same thing when using the retail definition.

We believe that confusion — and errors! — arise when you hear someone say the mark-up and the margin are the same (Definition B), then conclude that you simply multiply the cost by the mark-up (Definition A) to get the margin.

Here's an example: you assume that you can get a 40% margin by using a 40% mark-up (Definition A), so you do the following with an item costing $1.00:

WRONG!

$1.00 × 40% = $0.40 mark-up

Selling Price = $1.40

But this does not yield a 40% margin:

Sales	$1.40
– Cost	1.00
Gross Profit	$0.40

$$\text{Gross Profit Margin} = \frac{\text{Sales} - \text{Cost}}{\text{Sales}}$$

$$= \frac{1.40 - 1.00}{1.40}$$

$$= 28.6\%$$

As you can see, marking up the cost 40% produces only a 28.6% gross profit margin. Such a mistake would produce a shortfall of 12% — or $120,000, if sales were $1,000,000.

The moral: understand how to set prices; it's the gross profit you need. Mark-up only represents a concept to produce gross profit. If you confuse these issues, it can cost you dearly in dollars and cents.

Standard (Definition A) MARK-UP/MARGIN Table

MARGIN %	COST MULTIPLIER	MARK-UP %
$66\frac{2}{3}\%$	3.00	200%
60%	2.50	150%
50%	2.00	100%
$33\frac{1}{3}\%$	1.50	50%
25%	1.33	$33\frac{1}{3}\%$

Now try a few examples using a cost of $1.00 to verify that it works — and how it works.

Lake's Pharmacy
Ratio Analysis Spreadsheet

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BALANCE SHEET RATIOS: Stability (or "Staying Power")							
1.	**Current**	Current Assets / Current Liabilities	1.91	2.18	***1.09***	3.60	574,400 / 528,900
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3.	**Debt-to-Worth**	Total Liabilities / Net Worth	1.00	.76	***2.3***	0.48	578,900 / 251,200
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4.	**Gross Margin**	Gross Profit / Sales	25.8%	23.6%	***19.2%***	23.2%	604,800 / 3,150,000
5	**Net Margin**	Net Profit Before Tax / Sales	4.0%	2.7%	***1.0%***	2.7%	31,100 / 3,150,000
PRODUCTIVITY RATIOS:							
6.	**Sales per Employee**	Sales / Total Employees	$340K	$345K	***$394K***	$447K	3,150,000 / 8
7.	**Sales per Sq. Foot**	Sales / Square Feet	$1,000	$1,118	***$1,050***	$1,161	3,150,000 / 3,000
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8.	**Sales-to-Assets**	Sales / Total Assets	4.67	4.80	***3.79***	5.47	3,150,000 / 830,100
9.	**Return on Assets**	Net Profit Before Tax / Total Assets	18.7%	12.9%	***3.7%***	12.56%	31,100 / 830,100
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17.	**Average Payment Period-Days**	365 / Accts. Pay. Turnover	36	30	***36***	18	365/10.1

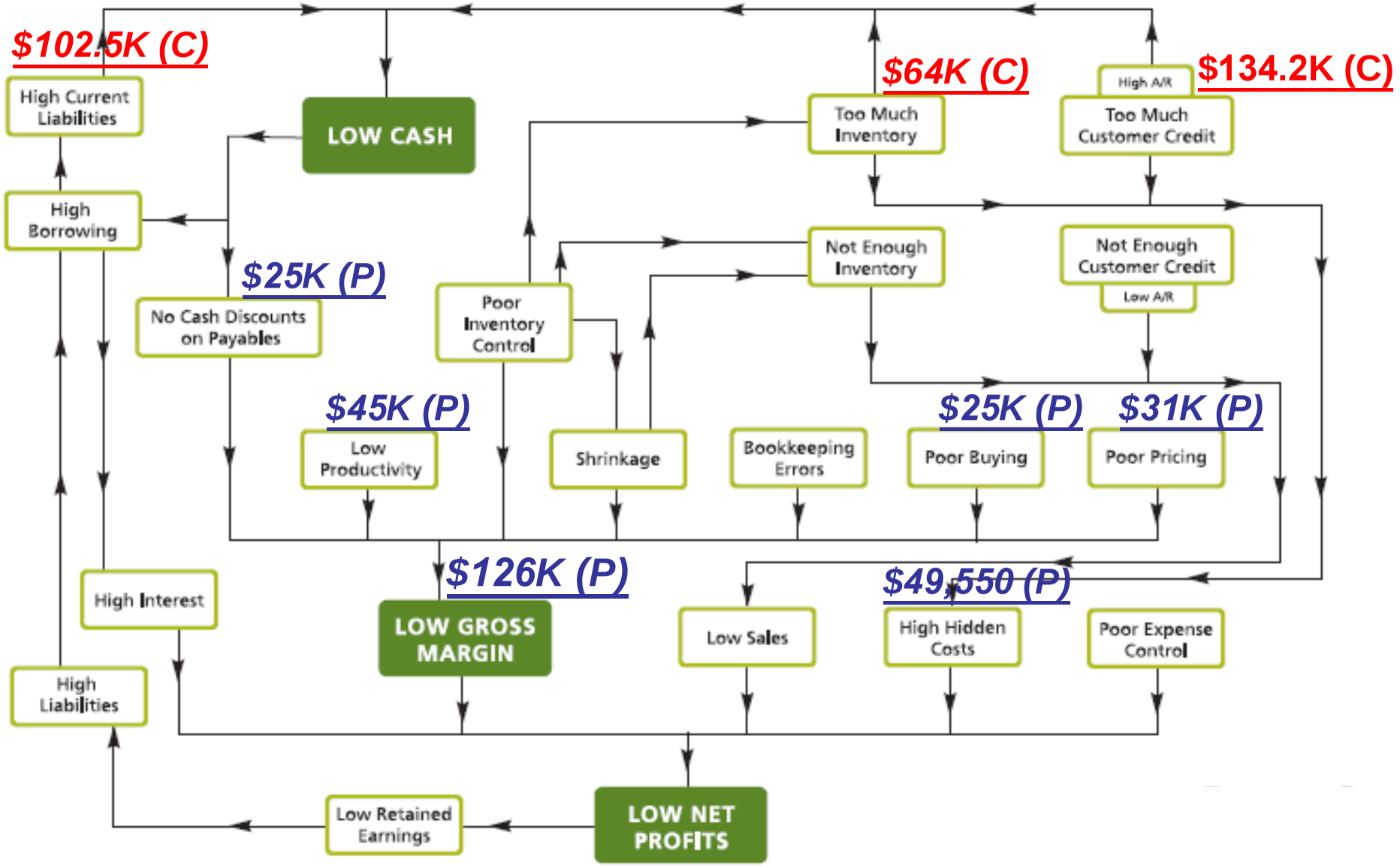
All values from 2009 NCPA Digest

Profit Mastery Assessment (PMA)
Summary Report
Lake's Pharmacy

	Cash	Profit (NPBT)
Inventory	$64,000	
Hidden Costs & Interest		$16,000
A/R	$134,200	
Hidden Costs & Interest		$33,550
Gross Margin		$126,000
Labor		$45,000
Buying		$25,000
Pricing		$31,000
Cash Discounts		$25,000
Refinance	$102,500	
Other		
Other		
Other		
Totals	$300,700	$175,500

The Road Map

Cause-and-effect relationships leading to financial distress.



NCPA National Convention
October 12, 2015
Washington, DC

Program Title: "Profit Mastery: It's All About Gross Margin - the Primary Controllable Profit Drivers"

(1 Hour 30 Minutes)

Assessment Questions (Answers in BOLD)

1. The Financial Operating Cycle includes:

   a. The P&L
   b. **The Balance Sheet**
   c. Company Tax Return
   d. Bank Loans
   e. Inventory

2. Which of the following are uses for net profit in a pharmacy business?

   a. Dividends
   b. **Repay Debt**
   c. Open A New Location
   d. Lease Equipment
   e. Buy Assets

3. Identify the three basic components of the Working Capital Cycle. **Cash, Inventory, Accounts Receivable**

4. A pharmacy's Debt-to-Worth ratio moves from 2.1 to 3.7 from one year to the next. Is the company becoming more, or less, risky? **More**

5. Identify at lease two possible causes of a shrinking gross profit margin.

   Shrinkage
   Poor bookkeeping
   Poor pricing
   Poor inventory control
   Not taking discounts
   Low productivity
   Poor buying

Bio

Steve LeFever, Chairman and Founder, Profit Mastery

Finance = boring. For Steve LeFever, this equation doesn't work.

With a superior command of his subject material, he makes finance compelling, interesting, and funny. Steve's unique ability to take complex topics and translate them into plain English separates him from the crowd.

Our clients routinely tell us they never expected to take away so much new knowledge from a keynote speech. Steve has a rare skill – being able to motivate business owners and advisors to enthusiastically explore the financial workings of a business and change the areas that need changing. Steve will make you believe that finance ≠ boring; instead you'll agree with him when he says, "Finance is fun!"

Part comedian, part financial manager, former commercial banker, current entrepreneur, and 100% world-class presenter, Steve drives home his message with a no-nonsense, laugh-out-loud approach that makes him the top-rated presenter at virtually every conference he attends. For over 20 years, Steve has combined humor and practical knowledge in hard-hitting, substantive presentations. His ratings currently rank him as the highlight of our clients' conventions in a wide spectrum of industries.

An internationally-recognized author and advocate for independent business, Steve's book, "Profit Mastery: Knowledge-Driven Financial Performance" has sold over one million copies.

Steve has travelled widely, and the Profit Mastery program has been presented on three continents in eight languages over two decades to hundreds of thousands of business owners, managers, commercial bankers, accountants, and business coaches.

Compelling Subject Matter - Financial management education is repeatedly cited as the single greatest need for business owners across all industries. Steve LeFever is the acknowledged expert on the subject. Our educational programs take the mystery out of the numbers. Audience members with differing levels of expertise will gain specific tools that can be applied immediately to improve the financial health of their companies.

Industry Knowledge - Steve possesses a breadth of knowledge and experience in banking, finance, and small business management. His work with the Risk Management Association (RMA), the Association of Small Business Development Centers (ASBDC), and financial institutions around the globe help keep his insights sharp and his information relevant to business owners, operators, and managers.

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