Watching the bottom line

Small business owners must watch for the high price of inflation

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There is a lot of talk today about inflation and what impact rising rates could have on the economy. For some, inflation may seem like something not to be overly concerned about. After all, what control does one individual have over large-scale or general economic factors? However, if you are a small business owner, inflation is something you need to be watching very carefully and planning around as it can have a very real and negative impact on your business's cash flow, agility and most importantly, profitability.

To start, let us unpack what inflation is. Inflation is the increase in price level of goods and services over a specified time and is often expressed as a rate. For example, if something cost $1 last year and is now $1.05 this year, the inflation rate for that product would be presented as 5%. For consumers and businesses, when inflation occurs, the money in their bank account does not buy as much as it used to and as a result, you are faced with purchasing less in quantity or spending more for the same amount.

Last month, the Bureau of Labor Statistics reported the biggest surge in inflation in 13 years. Consumer prices rose 5% between May 2020 and May 2021 with some of the key index areas seeing major spikes including gas prices (up 52%), airline tickets (up 24%), hotel rooms (up 7%), and clothing (up 3%). In addition, the supply chain for goods has also been severely impacted by the pandemic, ice storms, raw materials shortages and supply route issues — all of which have contributed generally to cost increases for small business owners. Combine the rising supply chain costs with labor shortages, a particular issue here in our region, and suddenly, a small business owner could start to feel their finances getting seriously squeezed.

While economists generally do not predict we will see inflation rates like the 1970s where inflation rates averaged 7.1% and interest rates rose to almost 20%, there is still reason for small business owners to be keeping a close eye on this. Some of the challenges that will likely become a reality are: having less "wiggle room" should financial missteps happen, increased inventory costs mean you have less on hand to sell, cash flow becomes tight as accounts receivable become slower to get paid, or employee wage demands exceed what you

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can afford to pay.

If any of this sounds familiar or you are just generally wanting to make sure that you are prepared, you can start by ensuring you are looking at the right financial indicators for your business. One of the most dangerous business management strategies an owner can employ is relying solely on sales data (such as point of sale reports) or revenue reports to be their financial indicator for the health of their business. Especially right now, when most businesses are enjoying the post-pandemic, high season rush of business, these reports could be telling a false tale of what is happening below the surface where cost of goods, labor and other expense increases could be eating into margins and ultimately profitability.

So, what should you be looking at? To start with, you should be analyzing your key financial statements at the end of every month, starting with your profit and loss statement, which can give you two key indicators: gross profit margin and net income margin.

Gross profit is the money a company earns after subtracting the cost of producing and selling its products, or cost of goods. When expressed as a percentage this becomes the gross profit margin (calculated as total revenue minus total cost of goods sold divided by total revenue). When looked at as a comparison monthly it can illustrate how effectively you are generating revenue from each dollar of cost. For example, if you had a gross margin in April 2021 of 33% but you saw that go down to 30% in May and then to 28% in June, this might start to indicate that you have some cost increases happening in your supply chain or production labor that you are not accounting for in your product or service pricing strategy and you may need to make some immediate adjustments.

The next indicator to look at is net income, or the company's profit after all its expenses have been deducted from revenues — often referred to as "the bottom line" due to its position at the bottom of the profit and loss statement. When expressed as a percentage this is referred to as the net profit margin and is calculated by dividing net income by revenue. This percentage, when analyzed over time, is one of the most important indicators for how well your business is doing overall as it tells you whether you are generating enough revenue from your sales to cover the cost of your products and services and if you are containing your operating costs. For example, say your gross margin was flat (for example staying at 30% each month — indicating you are doing a good job of managing your pricing and cost of goods sold) but your net profit margin was decreasing month-to-month. This might be an indication that an expense area of your business was experiencing an increase that you need to address (for example, you need to reduce that expense or generate more revenue to cover it).

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So, back to inflation and why business owners need to be looking at this carefully. The reality is that likely costs are going up for your business and if you do not know where and take immediate action to mitigate this, your business will suffer. The bottom line is that you've got to be watching the bottom line!

If you need help understanding this for your business, the advising team at the Small Business Development Center can help. Email sbdc@clatsopcc.edu or visit www.oregonsbdc.com/clatsop for more information.

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