Retail Financial Services

2801 Dixon Street ◆ PO Box 8033 ◆ Stevens Point, WI 54481-8033

Joseph Jones
The Hardware Company, Inc.
1111 Highway 15
Any Town, USA 99999

Hello Joe:

The recently completed remodeling and expansion of your store is starting to have positive effects on its financial performance.

For the second consecutive month, your store recorded double-digit sales increases. The business has now overcome the sales slide which occurred during the project, and is now showing a 2.1% sales increase for the year. Congratulations!

Your 16% increase in sales for the month compares to an average increase of 3.2% in November among all hardware stores using our accounting services. Meanwhile, those same stores are now averaging a 2.5% increase in sales volume for the year.

The joint effort between you and your wholesaler to improve your margin is also paying off. Your gross margin has increased by a full 2.8% over last year and now stands at 39.76%. Meanwhile, net Rental Department Income continues to be strong, increasing by more than 7.7% for the year. The combination of these two means the store has generated more than $43,700 of additional gross profit in 2005.

You still need to keep a close eye on your inventory. With the expansion, we knew inventory would be increasing. But, please note the downward trend in each of the following three inventory/ profitability measurements:

	Nov 2004	Nov 2005
Sales-to-inventory	4.60	3.90
Inventory turnover	2.90	2.35
GMROI	170.09	155.11

Don't be too alarmed, because if your sales volume continues growing as it has the past two months, these ratios will gradually improve. But, if sales start to level off, you need to make sure that your overall inventory doesn't continue to climb and put a huge crimp in your cash flow. At this time, a total inventory of $275,000 - $285,000 looks about right for your store.

Continued on back

800-888-1817 ◆ 715-341-7100 ◆ Fax 715-341-4080
www.retailfinancialservices.biz

As planned, the additional help you brought in to assist in the remodeling project has caused a temporary jump in your operating expenses. Now that the project is just about complete, Payroll and Employee Expenses (which ran at 30.8% for the month, and are running at 28.3% for the year) need to be brought back in line with sales. For a store of your size, total Payroll and Employee Expense should average no more than 22% of net sales. Given that the remainder of your other major operating expenses are in line with where they need to be, getting your payroll costs back in line is one of the final elements to generating consistent, and improved, net profit for your store.

The biggest change on the Balance Sheet, compared to last year, is that the store has about $31,000 more in current bills which will be coming due in the near future. Although you've had a modest increase in your cash balances, it doesn't appear that all of the obligations coming due can be paid without dropping your operating cash to dangerously low levels. Therefore, you may need to draw on your bank line of credit again. That credit line has already increased by over $52,000 in the past twelve months, and you should communicate with your banker that you may be drawing upon it again shortly.

Given the store's solid equity position, borrowing for the short term is not a big problem. But the store soon needs to start generating enough cash to sustain itself and pay its regular obligations without borrowing. For this to happen, I'll go back to two points touched upon earlier. One, get the payroll expenses under control so the business can get back to earning profits every month; and two, closely monitor the inventory levels and inventory performance measurements.

Looking at your income tax situation, it now seems likely the S-corporation will generate a loss for the year. However, with the recent up-tick in sales and the expense of the remodeling behind you, the store appears poised for a return to profits next year. Since we don't need any further write-offs this year, you may want to hold off on purchasing any more depreciable assets until after January 1. That way, we can utilize the Section 179 deduction and elect to fully depreciate any new assets next year, thereby reducing or eliminating the taxes due on what I anticipate to be a profitable year for the store.

As always Joe, I encourage you to look over the financial statements and to please give me a phone call if you'd like to discuss anything in more detail.

Sincerely,

John J. Haka
Accountant