Transcription

Financial Statements, MIS & KPIs

Introduction to Financial Statements

As I told, I made a series of mistakes. Series of mistakes means I made so many mistakes. It's not about the mistakes, actually from every mistake you can learn. Actually the success is what you know kind of you made so many mistakes but to be able to you know kind of create success because be able to also create something successful. Many mistakes as I told you. I did not even understand you know what the difference between balance sheet and P&L is. That was my understanding of finance.

If I am conservative, if I am approaching the business as a frugal, I can't have somebody who is like flamboyant because the values and the beliefs are different. Whereas certainly if I am not a data oriented guy, we should have somebody who is a data oriented guy. Skills, if I cannot do marketing, we need somebody who is marketing. I cannot read a balance sheet; we need a great guy who reads balance sheet.

It was fascinating to hear from Mrurugavel about his ignorance when it comes to understanding financial statements and how it affected him; I think from listening to Mrurugavel talk it was very clear to us that it is very important for entrepreneurs to understand basic financial statements. As an entrepreneur you need not be an expert at everything but it is important for you to have a basic understanding of critical elements to ensure your success. That matter we also heard Phaninder Sama of RedBus talk about why it is very important to have people who understand balance sheets and other financial statements. So in this session what we are going to do is to look at the three most important types of financial statements .i.e.1. Balance sheet, 2. Income statement, 3. Cash flow statements. Next we will look into the utility of management information systems also referred to as MIS and also understand the KPIs and unit metrics that are important for an entrepreneur to track.

Financial statements give you the review of your monitory performance over a period of time. From the financial statements an entrepreneur can understand,

- What is the income he generated over a period of time,
- What were the related costs to generate that Income
- What were his liabilities
- What were the assets
- What were the cash inflows and outflows

There are typically 3 financial statements which are critical. They are profit and loss account balance sheet and cash flow statement.

Profit and loss account gives you an understanding of the income generated over a period of time.From a P/L account, you would basically know some of the key info – like, the revenues, the related Direct costs for earning those revenues, and the resultant gross profit, the overheads spent to run the business, and the net profits or losses of the company.

Let's take an example of a departmental store. The typical sales for a departmental store over a period will be through the various SKUs sold. The Direct Costs for these products sold could be– the Costs of procuring these SKUs, the Sales Staff of the store, store rent etc. The difference between these two that is there venues and the direct cost is a gross profit. This is very important component to understand from financial point of view. As an entrepreneur, you would want to know the gross profit of your business and how it is growing over a period of time.

If your gross profit is very thin, you have a very low margin and a very low possibility to grow your business. Under such circumstances maximizing your sales as much as possible is advisable.

On the other hand if your gross profit is on the higher side, you can actually experiment a lot with your business. You can invest more in your business because with scale you would become profitable much earlier. This would be something that your profit and loss account would indicate.

If you divide the gross profit by your revenue, it will give you gross profit percentage which is a key component to understand your performance.

The other component which is part of the profit and loss account is the indirect expenses. Extending our example of a departmental store – The costs of your corporate office for running these departmental stores could be termed as Indirect Expenses. The corporate office is not a dedicated space through which you are selling these items. The cost of running these department stores is a direct cost but the cost of running the office is an indirect cost. Typically the key difference between Direct and Indirect costs is that Direct Costs tend to be of a variable nature, and increase proportionately with the sales, whereas Indirect Costs will not increase in the same proportion as the sales, and with increase in size, these costs as a % of sales tend to reduce.

Balance Sheet gives you the snap shot of the assets and liabilities of a company as on a particular date. It can be looked at from 4 components. It has fixed assets, the shareholder's funds, the borrowings and the net working capital. Now let's understand each of them independently. Fixed assets include land, machinery, equipment, buildings and other durable, generally capital-intensive assets. Shareholders' equity is the money attributable to a business' owners, meaning its shareholders.

It is also known as "net worth," since it is equivalent to the total assets of a company minus its liabilities, that is, the debt it owes to non-shareholders. A company has to pay for all the things it owns (assets) by either borrowing money (taking on liabilities) or through investments from investors (issuing shareholders' equity). Net working capital is the difference between current assets and current liabilities. Typical components of current assets would be the inventory, debtors or receivable, advances etc. The current liabilities would include creditors, trade payable or any other short-term provisions or tax liabilities. The balance sheets gets its name from the fact that the two sides of the equation above – assets on the one side and liabilities plus shareholders' equity on the other – must balance out.

Now let's understand what cash flow statement is. Cash flow statement tells you about the cash inflows and outflows over a period. The CFS allows investors to understand how a company's operations are running, where its money is coming from, and how it is being spent. The cash flow statement is distinct from the income statement and balance sheet because it does not include the amount of future incoming and outgoing cash that has been recorded on credit. Therefore, cash is not the same as net income, which, on the income statement and balance sheet, includes cash sales and sales made on credit.

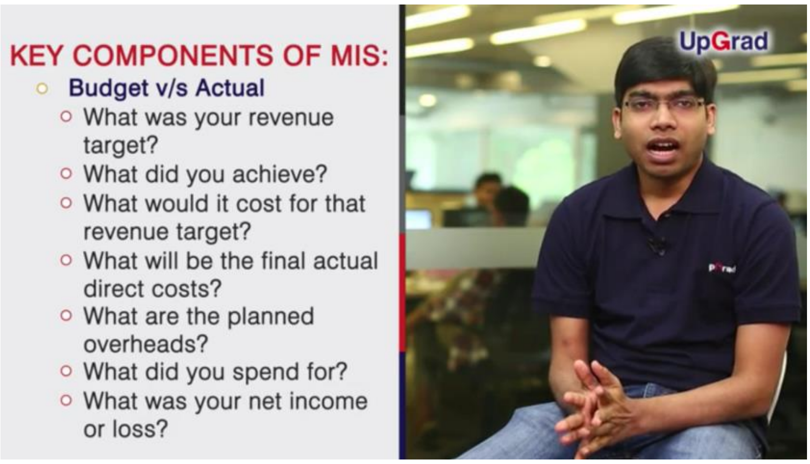
The cash flow statement is partitioned into three segments, namely: cash flow resulting from operating activities - this basically indicates what has been the cash inflow or outflow from the business operations, i.e. from sales, after paying your overheads and your creditors etc., (i.e. cash profit, + net cash flow to working capital)cash flow resulting from investing activities – these indicate investments in fixed assets / any long term investments ,Cash flow resulting from financing activities – i.e. the money invested in the company either by shareholders, or by borrowing through various channels, and if any dividend or interest payout to the same is there, is included here.

Management Information Systems

So by now we have understood the importance of and the essence of key financial statements like the balance sheets, the profit and loss statements and the cash flow statements. Now that we have understood this we know that it is very important to an entrepreneur to track each of these financial statements to ensure the success of his venture. But that being said it is also important to the entrepreneur to have a centralized coding system which gives him summarized reports using which he can take key business decisions. Such systems are typically referred to as management information systems or MIS which provide entrepreneur with the required reports in order to insightful decision into running the business. Let us listen to our subject matter expert talk about MIS and its importance.

For most entrepreneurs, management information systems are a way to track their progress. However, some entrepreneur's think of MIS as an investor's requirement and that it's not necessary for them. They perceive that it's a way for their investors to judge them on their performance akin to a scorecard. Let me tell you one thing - MIS or management information systems are as important for you as an entrepreneur as they are to an investor. You will be way ahead of other entrepreneurs if you are in the practice of creating management information systems on a periodic basis.

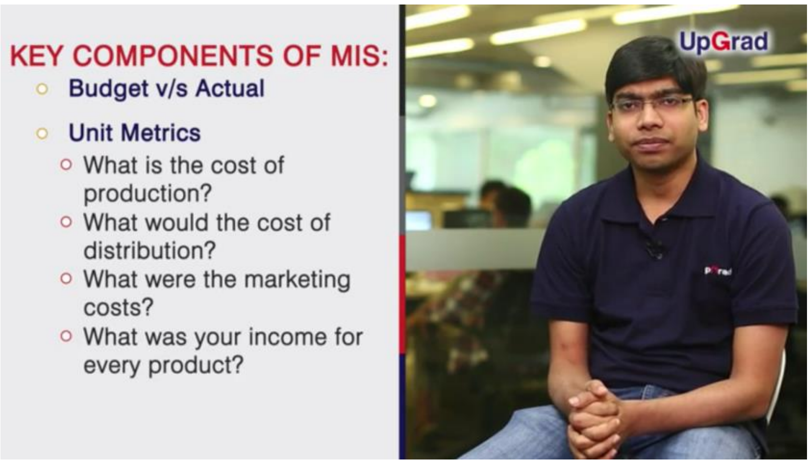
Now, let us understand this through an example, if you were a restaurant owner and you made budgets for spending on marketing initiatives where you divided the expenditure equally among three initiatives – Facebook, pamphlet distribution and let's say an advertisement on Zomato. At the end of the month, you would understand the conversion from each of these verticals. For instance, if you spent 35,000 rupees each on these three platforms and you earned 50,000, 40,000 and 70,000 from revenues from these three platforms, it is evident that Zomato was the most efficient channel for marketing if you look at the statements but if you don't look at the statements, you will not be able to see that in the next month you should increase your marketing budget allocation towards Zomato and this is where MIS helps you. It helps in predicting results in the near future. Not only does it give internal stakeholders a better understanding of the performance, it also gives your external stakeholders a good understanding of your progress that you planned for versus your previous performance.



MIS reports should be a periodical exercise and each periodic movement should be compared in order to understand the major deviations over the period and the reasons for the same. Let's understand the key components of a Good MIS. The first component would be budget vs actual expenditure. As we discussed earlier, the most important aspect for an entrepreneur is to understand his performance over a period and compare it to the expected results for which you planned in the initial stages. By understanding this, he can correct his future course of action. Typically an MIS format will include the budget versus the actual expenditure with a line-by-line comparison of the items you had budgeted for against their actual performances. For example

- What was your revenue target?
- What did you achieve?
- What would it cost for those revenue target unit assumed and
- What will the final actual direct costs which you got?
- What with the overheads and
- What did you spend for and finally
- What was your net income or loss?

Understanding this would help you in recalibrating your plans for the future.



Other component to track would be the Unit Matrix, I.e per unit costs, which is key to understand for any entrepreneur. For example for a sale of one unit of a product,

- What is the cost of production?
- What would the cost of distribution
- What were the marketing costs and finally
- What was your income for every product?

Unit matrix helps you to understand the importance of each component of your cost structure and helps you focus on important areas which are driving the cost efficiency and improve on the areas which are leading to deviations from what you planned for.

The next part of MIS would be KPI's. They are indicators for your performance, which you would want to track on a regular basis. As understood earlier, KPI's would be typically identified as you start your business, but identifying them and monitoring them on a day to day basis is the key. As part of the MIS, one would look at how the performance against each of those KPI's has been over a period of time. Identifying 2-3 KPI's for each of your business activities will help you in monitoring your progress and keeping it as part of the monthly MIS will enable you to track it across periods and look at the trends.

For example let's look at customer acquisition costs as a key performance indicator for any kind of business. These days, customer acquisition cost is an important tool to measure your marketing performances for acquiring new customers. For instance, for e-commerce companies, typically the customer acquisition cost would be in the range of 400 to 500 rupees per customer. Now in an initial business, it's pretty easy for someone to spend much higher than these numbers or much lower but when you compare it to what your plans were and what are your benchmarks, you would know where you stand and what you need to correct in order to come to the long-term goal of 400 to 500 rupees per customer acquired. So these are typically the KPI’s which will give you an indication of your performance and keeping them in your MIS would give you an understanding of the trends on these KPIs. For a start-up, understanding these trends is important because as you grow, these indicators will give you an understanding on the trajectory in which your cost is going, the trajectory of your customer acquisition and the trajectory on revenues.

The other components of MIS would be summary of your profit and loss account, the cash flow and the working capital positions. Looking at these on a monthly basis does help you to take informed decisions. Comparing your previous performances on your assumed budget with your current performance will give you a better understanding of your financial health as a startup. It may not be the most critical thing to look at all of these statements on a monthly basis but if you do so, I can assure you, you will be a lot more ahead of other Start-ups and it will definitely help you in the long run. For start-ups, it is crucial to keep track of performance, and this can be carried out effectively with the help of MIS, or Management Information Systems. MIS reports should be specifically designed to contain information that would help you as an entrepreneur, keep track of the venture's progress and performance. There is not cast-in-stone format for MIS that you must follow. What's more important is that what you want to be looking at on a weekly, monthly or quarterly basis has a logical structure, and allows you to compare products against other products, resources, and the same across timelines.

For example when we started UpGrad, the key components we were looking at were quite different from what we are looking at today, for instance in the initial phases the hiring was a very important aspect for us so we were very closely tracking the number of people we are hiring, the hiring pipeline vs what is the requirement, and beyond that what was our burn rate since we were not earning much revenue and we were in the development phase what was the spend on the technology platform which we were developing. As we grew along and we started production on our courses we started to monitor what kind of spends we are doing on recording the lectures what kind of efficiency is their how many number of hours of shoot we are doing, what is the cost per hour of those shoot so on and so forth. As we grow along and today we are tracking the profitability vs the targets, the number of students, their engagement on the platform, future pipeline of courses etc. - so just to give you an example on how would you evolve looking at your financial statements all your monthly information statements as you grow along as a startup.

Financial Key Performance Indicators

Repeat is important. Frequency of next purchase is important and the third parameter is what you earn, what's your gross margin or contribution margin in that transaction? That is going to be important. Put all of these together and then you will arrive at the right mix and that will directionally guide you in terms of how much should you be spending on a customer and this changes from vertical to vertical, business to business, everything. So it's going to something which is intrinsic to you whenever you are comparing it with others, ensure you ask them these other set of question also along with it because that's the cohesive thing. The other metric that most people use is the payback period where they say that it's more of a cohort, where you say that "I have spent X amount of money on acquiring, Y amount of customers in a particular month, by what time do I recover the X on the Y by basis of their repeat transactions?

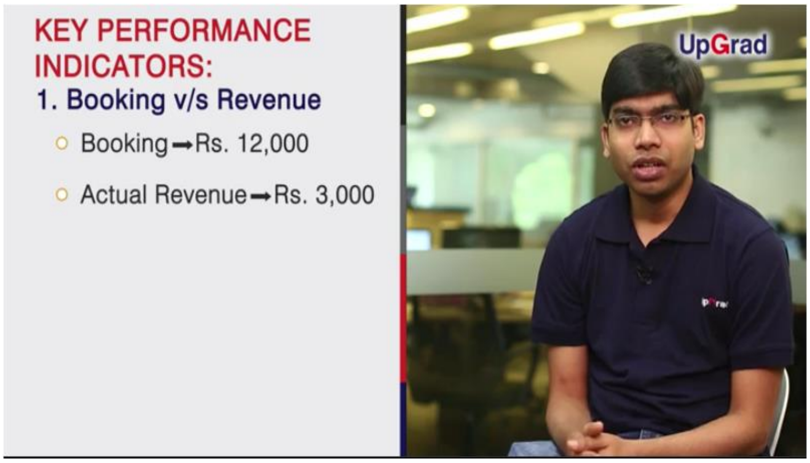
In the subsequent month." So it's a cohort that you are building on Y, which is the customer base that you've acquired. So in the next 1 year, if this customer base is transacting so many times that you are able to recover X amount of money on them, then you get a payback period for your customer. These are the two matrices that would be very important for internet businesses like ours to kind of measure. When you calculate the cost of customer acquisition, it is going to be very important for you to be alert of what cost needs to be taken and what cost need to be not taken in. For example, if you are going to use let's say the cost of your PR agency, you can't really put a customer acquisition cost to it. It's an ongoing cost.

By that logic you have to put everybody manpower or every operations cost into it. Let's say, for example, if you add the cost of a creative agency, you may not want to add that because that's not really a directly attributable to an acquisition cost but any kind of advertising, media cost that you do, necessarily need to be incorporated into a cost of customer acquisition. For example, whatever you are spending on Facebook, whatever you are spending in media spends, in television, for example, anything you do in or the spends on displays etc., all of the media cost need to be definitely included in your cost of customer acquisition. You may choose to not include the cost of creative or supporting functions, which could be a media agency, which could be a creative agency etc. in the cost of customer acquisition.

Let me answer the whole ticket size and the LTV and all that repeat buying behaviour. I think in a business like ours when you are creating category, we are seeing people come back every 6 months to buy a pair of specs, which is of course the industry. We are giving you the example of ATV, I mean our ATV has doubled over the last 2 years. In fact, our earning per order right now is the highest in any other E-commerce business You can pick up any commerce business across sectors and I can guarantee you the money that they make absolute amount of money that they make in across – you can pick up 15000 average ticket size business or us, our earning per order will be higher than any other business. So, to me that happens only when true value is getting created. So, people will pay up for it. I think those things can all be figured out.

We heard Richa from Zivame and Piyush from Lenskart talk about key performance indicators like customer acquisition cost, cohort analysis and the average revenue per user. These are very important metrics that an entrepreneur should track in order to ensure the success of his venture. I am sure there are more such key performance indicators that are essential for an entrepreneur to track. So let us listen to our subject matter experts talk about some of these KPIs.

Another crucial element to your business, are KPIs or Key Performance Indicators. KPI is a measurable value that demonstrates how effectively a company is achieving key business objectives. Organizations use KPIs to evaluate their success at reaching targets.

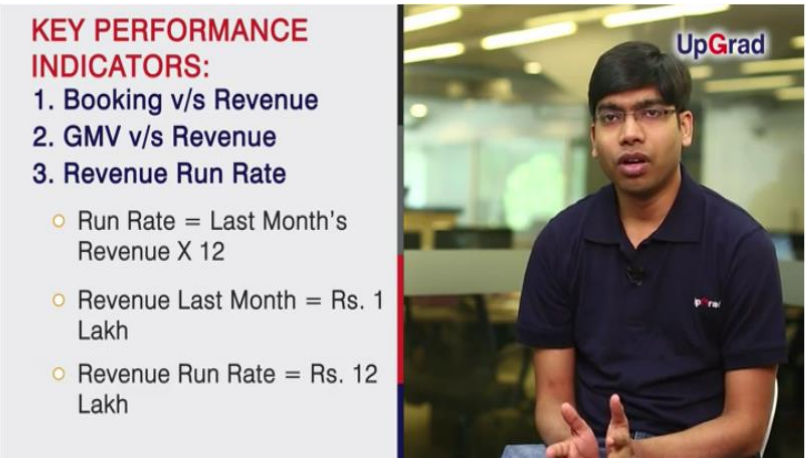


Let's look at some important financial KPI's. Booking vs revenue for instance which is applicable in the case of subscription-life models, let's take an example - where you are a gym, and have sold an annual gym membership for 12000 rupees on the first day of January. At the financial year close of March 31st, your 'Bookings' would be 12000, since that is more of an internal tracking, basis which you will judge sales team performance. Whereas, your actual 'Revenue' would be 3000, proportionate to the time period passed, which would be how it would actually reflect in your accounts. While tracking "Revenue" gives you the actual health of the company as on date, tracking 'Bookings' helps you understand the potential future earnings.

Now, let us assume you are online marketplace, in which case your KPI would be GMV vs revenue. So, let us assume, on your online marketplace, you have sold ABC brand's shoe online. Its MRP is Rs 2000, of which your commission from the seller is 10% on MRP, which is Rs. 200. In this case, GMV is 2000 and your Revenue is 200. Tracking GMV helps companies, understand their share in the market they operate in, while tracking 'Revenue', of course helps understand and track the performance of the company.

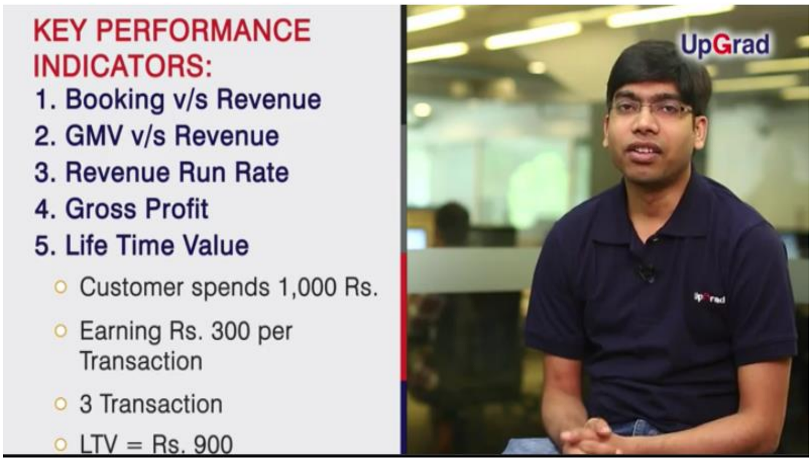
GMV is gross merchandize value. Gross merchandize value is a notional concept when it comes to a marketplace like Shopclues. The term actually typically comes from a more inventory led model, where people are buying and selling. Companies like I would say Amazon would probably use GMV not to report the business, GMV first is a comparative term that allows you to compare a market place with an inventory based model. It is basically sum total of the gross value of the merchandize that are sold on the platform though the business makes its revenue from a certain percentage of the GMV that we take as our service fee. So, revenues for companies like Shopclues or ebay or Tow Bow would be the take rate that is a percentage of the GMV that is sold. So revenue would be the take rate, GMV is the sum total of the gross merchandize value.

By take rate - it is the commission that the platform charges from the merchants. So, revenue is really the money that the platform makes and GMV is the sum total of the entire value of the products that are been sold on the platform.

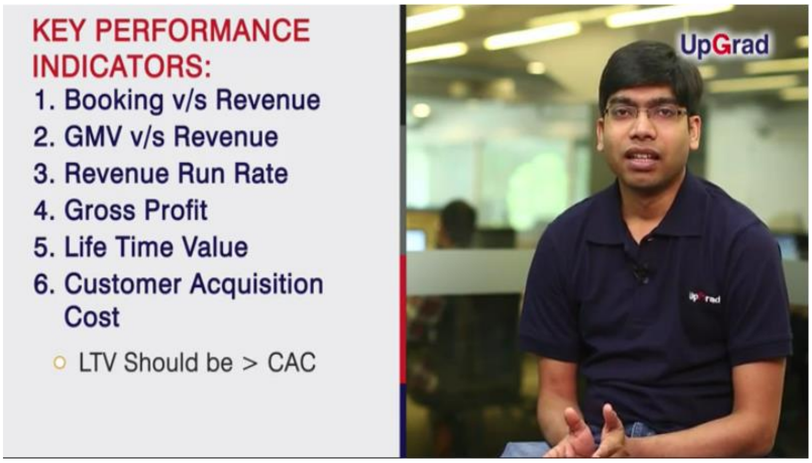


Let's look at another KPI. Revenue run rate versus total revenue. What is revenue run rate? This is most widely used by digital businesses, where you measure the revenue of the last month and multiply that by 12 to understand the "revenue run rate". So if you had one lakh rupees as revenue for the last month, your Revenue run rate would be 12 lakhs. Chances, of course, are that at the yearend, you might actually be well-above or well-below, depending on how you perform. Tracking Revenue Run rate helps companies progressively keep track of their revenue performance and take corrective measures in-time, rather than at the end of the evaluation time period.

Another crucial KPI is Gross profit and gross profit percentage. Gross profit is the profit you've earned after deducting all your direct costs from the revenue you have earned. Keeping track of this gives a good sense to an entrepreneur of the health of his business. If your gross profit, as a percentage of the revenue, is healthy, then it is a clear indication that you should be spending more time to increase sales, so that gross profit grows, leading to the profitability of the business in general. But if you find that your gross profit percentage is low or negative, then you have a tough task ahead as you either need to reduce costs to increase your profitability chances or you might have to increase your prices to take up revenues. It's important to study trends related to gross profits, as volumes might be impacting the same tremendously, in which case you should then actively work to get on board new and more price competitive vendors to be able to achieve better margins. Tracking Gross profit also helps compare between product lines, and decide resource allocation for scaling up.

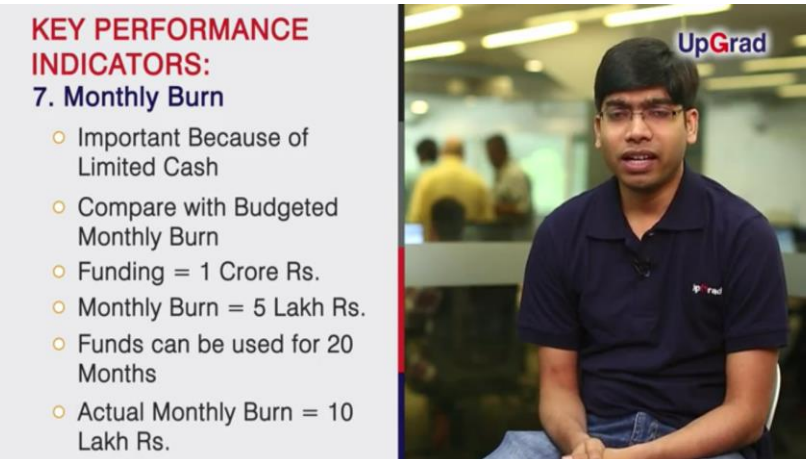


A popular KPI to track, especially for new age e-commerce venture, is LTV or Lifetime Value. So long as your product or service is good, a purchasing customer would be purchasing with you at least a few more times. For example, if a customer spends 1000 rupees with you on one transaction, in which your company earns 300 rupees, and the customer is likely to come back for 3 more such purchases, then the lifetime value of this customer is 900 rupees.

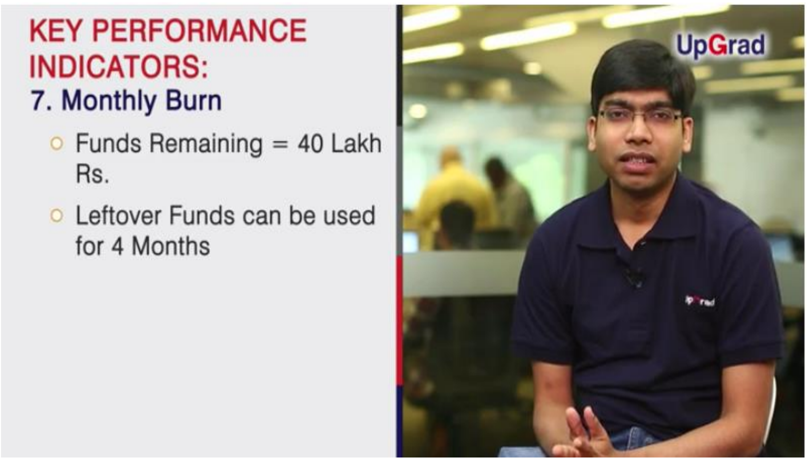


Continuing the previous example, let’s talk about another KPI – the Customer Acquisition Cost or the CAC, CAC is the amount you spend to earn the 900 rupees we just saw was the Lifetime earnings from our customer. Let us assume that this cost totals to about 400 rupees per customer, in which case you have a profit of 500 on the customer. Needless to add, your LTV should be greater than your CAC, and if it isn’t, then either you reduce your CAC or take up your LTV.

If we are going to be looking at new customers that we are acquiring on a month on month basis, what is the cost of acquiring those customers? What we did was we took all our marketing cost and divided it by the new customers that we acquired in a particular month and that is how we arrived at the cost of customer acquisition. Ironically or this is not entirely the right approach of arriving at a cost of customer acquisition because you would have and every company spends money on retention also, you would have marketed to customers who have bought from Zivame on the same channels such as Facebook, on the same channels of SEM, I mean search, display etc. I would search Zivame and click on a paid link and come, I would have bought from that. So while technically this is not correct, but on a periodic level if you can look at from a trend analysis and say “hey, this is how my cost of customer acquisition is trending”, you know which way you are going, that’s number 1.



The other components would be monthly burn, so monthly burn again is very important for an entrepreneur to understand. When you are in your initial stage you are bootstrapping, every month you have limited cash flow available and you count on each of them. Most of the entrepreneurs know this number and it's important to track that when you compare this with what you had budgeted for. This will give you an understanding of when you'll be running out of your money. Like for instance you started with the funding of 1Cr and your assumption of monthly burn was 5 lakhs with then means you would be spending your money in 20 months. However, over the performance you had over the last six months you realize that you already spent 60 lakhs.



Now, you were left with forty lakhs and had the same rate of your historical six months your burn rate will lead you to only four more months of funding this is very different from what you invited for and you might have to look for funding much sooner than you had planned for. This is important for you to understand at every stage of your business that it's not too late for your business and you don't suffer on your growth path.

Monetization for us was a day 1 priority because we didn't have a lot of money. The understanding between me and my cofounder was, okay, we have probably an 18-24 month runway to have a small team and try out working and also our initial team members took big pay cuts. Most of them were earning like 30-40% of what they made before joining Freshdesk. And I and my co-founder were not taking any salaries at all. Our total burn was like 5K USD per month including everything.

Average revenue per user now this is another KPI which is close to what we looked at from an LTV but it's very different. Average revenue per user is effectively your total revenue divided by the total number of customers. You had all that period whereas the LTV was for your lifetime revenue per user of that particular user so both are very different.

Average revenue per user gives you a fair indication of what kind of the revenue you are earning from a customer and what is the mix of your customer base. Let's look at this example, in a service business if you have an IT firm and you have a revenue of 1 crore you have only 5 customers that means your average revenue per user is 20 lakhs that means, you are having customers with large ticket size. Average revenue per user is also metric and very different from what we looked at as LTV earlier. From each of the customer on a single transaction. Whereas, the LTV is the net earnings from one single customer over the lifetime of that customer so both are different, average revenue per user gives you a good understanding of how you want to grow your business and how many customers you need to acquire for that for example, continuing with our restaurant example earlier if you had a typical restaurant business you would have dine-in sales and delivery sales.

Looking at the average revenue per user on a dining sale versus the average revenue on delivery sales will give you an understanding of how many customers you need to acquire for each of your vertical. Identifying the average revenue per user for each of your verticals of business would give you an understanding of how many customers you need to acquire to achieve your targets and value should concentrate more on with. Some business metrics with financial relevance are conversion rate and cohort analysis. Now, what are conversion rates? For example an e-commerce website has various visitors coming on their website but this number doesn't give you any indication from a financial perspective. However, how many people ended up shopping out of the base who came on your website would make sense. This is your conversion rate. The conversion rate is effectively what your funnel is. Conversion is the measure of your efficiency of your funnel for example if you have one lakh visitors on your website and of which only 2000 customers buy. That means, you have a 2% conversion rate from the people who come on your website.

It might not be that relevant in initial phase but over the period conversion rate is a very important aspect through which the growth of your business is measured. From an investor's point of view business metrics suggest conversion rate would give them an understanding of the health of your business, how much money you need to invest more on a regular basis to attract growth for conversion rates. That means you are actually spending much more efficiently on your marketing initiatives and you can take risks if your conversion rates are low and you have a very low margin of error so that means you need to be very careful of where you spend.

Cohort analysis on the other hand measures the repeat behaviour of your customers. For example, if you acquire 1000 customers in a particular month; how many people churn over the period is measured by this cohort analysis, let's take this one symbol of 1000 and see in each of the month how many people of this 1000 are coming and buying again. For example, in a month there are only 600 people who are coming in and buying again and in the month 3 there are let's say only 360that means only sixty percent of your people are coming and repeating in each month. Higher the percentage or higher the repeat for any business is fine because it indicates that you need to spend much lesser and you would grow organically in the future much more with what you've already invested.

Now the KPI’s which you are looking at as an entrepreneur also will be very important with the scale or the stage of business you are at and it's important to identify your KPI’s from a long-term perspective such that you don't look at different KPI’s as you go along for instance when you are at the initial stages of your business when you establishing your product in the market you want to understand whether your project is a good market fit it or it's solving a problem you need to focus on the KPI’s from a point of view that these are giving you an indication of whether your product is solving the need for the market or for the customers how will you do that for instance if your conversion rate is high, and more and more people who visit your website do end up buying your product.

High repeat ratios at this stage also give the re-affirmation of the product market fit. Subscription businesses have very high cohorts since once these customers stick around for a longer period of time. When you grow and you establish your product in the market your focus on the KPI’s will be more from an optimization point of view; that is whether you can grow your market? If yes, how? And how you can cut your costs? For example – repeat behaviour is far more important when you are growing, since you have a large customer base already, and exploiting that would drive profitability as well as growth. You will focus more on your gross profit margins your CAC’s going down for instance and so on and so forth so it's very important for you as entrepreneur to understand the importance of the KPI’s you're looking at and relate to the stage of your business.

Summary – Financial Statements, MIS and Financial KPIs

This was a very interesting session where we understood the importance of financial statements and why it is critical to an entrepreneur to have a strong understanding of them.
We also looked at the three most important types of financial statements,

- The balance sheet
- The income statement also called as the profit and loss statement, and
- The cash flow statement

We saw that at some point of time the entrepreneur will have to pause and ask himself is the business making money. And is it profitable by looking at the income statement? Then he has to ask himself how much is the business owned and how much does the business owe by looking at the balance sheet. And then finally, it is of course very critical to in detail analyse the cash flow in order to make sure that the business is sustainable in the short and long run. Then we moved on to understand the management information systems and what are the key KPIs that a business needs to track. Hope you enjoyed this session and I look forward to seeing you soon.