Minding Your Business: How to Avoid the Seven Deadly Financial Pitfalls

by Keith Stephens

"Help! We've been operating our center for ten years. We've got an excellent location, a great facility, dedicated staff; our parents love us. But it's always a struggle to make ends meet. What's our problem?"

When I give financial management seminars for **Child Care Information Exchange**, center directors and owners often come to me with similar stories. When I sit down with them to go over their situation, invariably they have succumbed to one of the following pitfalls.

Pitfall #1—Dancing in the Dark

A common management style of child care administrators is MBC—"Management by Checkbook." When the balance in the checkbook is high, they spend. When the balance is low, they cut back.

This method is quick and easy, and, when things are running smoothly, it appears to get the job done. Unfortunately, it is too quick and too easy.

If your center is thrown into a financial crisis, your checkbook will tell you that you have no money, but not why. If your revenues rise, your checkbook will tell you how much money you have in the bank, but not how long the period of prosperity is likely to continue.

A center director or owner needs to be able to look ahead to see if the center will be operating in the black or red in the coming months. If the outlook is bleak, she needs to know why so she can take corrective action. If the outlook is rosy, she needs to plan ahead so that any surpluses are put to good use and not wasted.

To be an effective manager, you need to keep your finger on the pulse of your organization's financial performance. To steer your center out of the dark, you need tools—some basic financial reports including a balance sheet, an income statement, and a working cash flow projection. These reports need to be reviewed by you at least monthly. The balance of this article will illustrate how they can be instrumental in the success of your center.

Pitfall #2—Born to Lose

More and more emphasis is being placed by centers on attracting customers by delivering a high quality service. This is a welcome trend. Too often, however, center operators place so much emphasis on enhancing the quality of their services that they lock themselves into costs that can't be supported by potential income.

For example, in my article, "Is Child Care a Good Business?," in the June 1990 **Exchange**, I observed that many child care businesses are doomed from the outset because they commit to facility costs that are excessive.

If your center is constantly running short of cash, it may be that your breakeven point is too high. Your breakeven point is the number of children you will have to enroll at a set fee level in order to cover your expenses.

For example, if you have a center licensed for 120 children and you need 110 children to be enrolled at all times in order to break even, your likelihood of succeeding is not great. In order to hit this level of enrollment, your center will need to operate at 92% of capacity at all times. Very few centers (even centers with waiting lists) operate at this high an occupancy rate.

A breakeven point can also be too high in terms of absolute numbers of children. A breakeven point of 120 children in a highly competitive market may be too high to achieve.

Pitfall #3—Creeping Costs

Your cost of doing business needs to be monitored closely. You should start every year with a budget setting limits on every expense category and then work to maintain spending within those limits. The **Income Statement** is your best tool for monitoring expenses.

You have greater ability to visualize what is happening with spending if you break out your expenses in your income statement in broad categories rather than detailed accounts. I recommend looking at staffing, occupancy, food, transportation, advertising, program, and administration. By monitoring these consolidated categories, you have more likelihood of drawing meaningful conclusions than if you try to watch 50 or 60 specific accounts.

To get a better picture of what's happening, you should convert the dollar amounts in your expense categories into percentages of your total income. Comparing these percentages on a month by month and a year by year basis will enable you to quickly detect any expense accounts that are out of line.

A related tool for monitoring expenses is the **Operating Income Ratio.** This ratio tells how efficiently your organization is operating. It allows you to compare the expenses against the revenues generated by your center. If this ratio is too low, it may indicate that you should increase your fees or institute a stringent cost control system.

Nationwide, the operating income ratio for for profit centers is in the 10% range. If your ratio falls below 10%, your operation may be in less than sound condition, warranting a close look at all income and expense categories.

(**Note:** If you operate a for profit center, you can see how your center's income and expenses compare with industry averages by participating in our child care cost study. For more information, see the box on page 11.)

Pitfall #4—Underpricing

A careful analysis of your costs may reveal that (a) expenses are increasing, but that (b) most of the increases are unavoidable, and that therefore (c) unless something is done to increase revenues, your center will soon be operating in the red. The inevitable conclusion, of course, is that you need to raise your fees.

But raising fees is never an easy decision. If a substantial portion of your income comes from a third party such as a United Way agency or from your state government, this may be more of a political than an economic problem. If you are primarily dependent upon parent fees, it may be more of a psychological problem. You may be reluctant to raise fees for fear of driving away customers.

One way to prepare psychologically for a fee increase is to calculate how many children you could lose if you raised your fees and still maintain your current level of income. This will show you that if you raise your fees, you could lose some enrollment (often more than you would expect) and come out no worse than you are now, but with increased potential for generating revenues.

Pitfall #5—Iffy Income

Your organization may be in trouble if your revenues are stagnating or declining. As a manager, you need to detect these revenue problems before they become revenue disasters. Since revenues are directly tied to enrollment, you should have some means of monitoring enrollment on at least a weekly basis.

One way to do this is to divide your actual income for each week by the the potential income if the center was 100% full. In a large center, you may want to do this on a classroom by classroom basis as well as for the center as a whole.

At the beginning of the year, you should set a goal as to what percentage of potential income you want your center or each classroom to achieve. For example, you may determine that you need to operate at 75% of your potential income to balance the budget. Then use this as a gauge in reviewing the weekly numbers.

For best results, you should plot your goal and your results on a graph so that you can watch your progress visually. I am in favor of sharing this graphic demonstration of your progress in achieving your financial goals with your entire staff. You need their support and enthusiasm in achieving your goals.

A second approach to monitoring enrollment is the **Full Time Equivalent** report (see box for details). With this you will be able to track enrollment in each classroom and for your entire center on a daily basis. That way you can detect any negative trends early and take corrective action before serious problems develop.

Of course, once you detect an enrollment problem, you need to determine the cause. Is the decline due to seasonal factors (the typical summer slump), economic factors (that big layoff at Boeing last month),

Financial Tools for the Alert Executive

To exercise effective management over your center's financial performance, you should be utilizing the following financial tools:

Balance Sheet. This report tells you how much your organization is worth on a particular date. Often it is described as a photograph that captures what your organization owns (assets) and what it owes (liabilities) at a moment in time. The difference between the monetary value of your assets and your liabilities is your organization's net worth (described as "equity" in a for profit company and as "fund balance" in a non profit).

Income Statement. This delineates your organization's income and expenses over a period in time. The basic format of this statement shows income, less expenses, in order to determine "net profit or loss" (in a for profit company) or "excess of income over expenses" (in a non profit).

Cash Flow Projection. This is an estimate of how much cash you expect to receive and spend on a monthly basis. The basic set up of this report is as follows:

Opening cash balance
+ Cash received in month
– Cash disbursed in month
= Closing cash balance

Set up your cash flow projection by estimating receipts and disbursements for the upcoming 12 months with the "closing cash balance" automatically being transferred to the "opening cash balance" for each succeeding month. You may want to break out receipts and disbursements by major categories. Continually revise these figures as more accurate numbers become available.

Breakeven Analysis. This tool will reveal to you the point at which your income will equal your expenses. This may be expressed either in terms of dollars or numbers of children at a given fee level. In my next article for **Exchange**, I will provide a step by step guide for undertaking a breakeven analysis.

Operating Income Ratio. You compute this ratio by subtracting your operating expenses (excluding interest and income taxes) from your revenues and dividing the remainder by your revenues.

$$\frac{\text{Revenue} - \text{Operating Expenses}}{\text{Revenue}}$$

Full Time Equivalent Report. Each classroom turns in a report every day on how many full day slots were filled. For example, each child enrolled for a full day would be counted as 1, each child enrolled for a half day would be counted as .5, and each school age child might be counted as .3 (the exact numbers will depend upon how your program is structured). The total of these numbers will tell you what your FTE is for each classroom and for the center as a whole.

Accounts Receivable Aging Report. This report depicts how much money is owed to your center and how old these debts are. The typical format is:

Current =
30 Days =
60 Days =
90 Days =
Total =

Current Ratio. The current ratio is determined by dividing your current assets (cash and all other assets that can be converted into cash within one year) by your current liabilities (claims that must be repaid within one year).

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

demographic factors (your neighborhood is aging—there are fewer young families than before), service factors (the quality of care for children or your parent relations are slipping), or competitive factors (the local elementary school just opened a school age program)?

Some of these factors may be outside your control. If your local economy or your neighborhood demographics are changing, you may be fighting a losing battle. You may need to make the difficult decision to close your center and move to a better location.

It is, of course, much more difficult emotionally to close than to open. When you open a center, you experience the euphoria of success; when you close one, you are dealing with failure (whether it is your fault or not), and you will feel guilty about no longer providing care for many families who have come to depend on you.

Pitfall #6—The Check is in the Mail

When one family starts falling behind in their fee payments, this may have serious interpersonal implications for the director. When many families start falling behind, this will have serious financial implications for your center.

You cannot afford to let your accounts receivable get out of control. The more money customers owe you, the harder it will be emotionally to deal with and the less likely it is that you will collect what is owed to you.

To keep a handle on fee collections, it is critical to establish firm policies and procedures, to publicize these widely so all parents are aware of them, and to enforce them swiftly and consistently.

It is also important to monitor collections closely. Every few weeks, you should review an **Accounts Receivable Aging Report** to be sure that you are not falling behind in fee collections.

Pitfall #7—The Credit Crunch

In today's easy credit society, it is easy for individuals and organizations to slide imperceptibly into a serious debt crisis. That is why it is so important for you to review your **Balance Sheet** every month. You need to be aware of trends in your center's liabilities.

Another tool to use in gauging your center's financial position is the **Current Ratio.** This ratio is used by financial analysts to measure an organization's ability to pay its current debts.

The higher your current ratio, the more liquid your company is, and the easier it will be for you to pay your bills on time. However, if the ratio is too high, this may indicate that your organization has excess cash which might be put to better use. If your current ratio is greater than 2.5, look carefully at your cash balances and put your cash to its best advantage. You may want to pay off a long term debt, or consider expanding your business.

If the current ratio is too low, you are probably struggling to pay your bills. With a ratio under .5, you are in serious trouble, and need to take drastic action to generate additional cash or to buy some time on your current accounts payable.

To put your numbers in perspective, the seven largest publicly owned child care companies in 1988 had a composite current ratio of 1.43, with ratios ranging from 2.1 to .2 for the strongest and weakest companies.

In our survey of privately owned centers, their composite current ratio was 1.97.

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