BENCHMARKING BEST PRACTICES

Where to start & where to focus

Executive Summary and Table of Contents

Where to start & where to focus

Maybe an even better question:

Why should a company care about benchmarking?

If a horse is running a race by itself, it will win every time. And we all like receiving the big trophy. Unfortunately, though, commerce is anything but a single-horse race, and even a personal best doesn't necessarily secure the big trophy or land a new, big client. In each industry, there are many other competitors, and globalization will only make the race more close in the future.

Knowing where a company ranks in the race—before the starting bell, halfway through the race, and right before its conclusion—makes it easier for management to change its methods and influence the company's final position (if there is a "final position" at all in business). And while every company would like to know its ranking in the consumer's mind, there are some objective measures of success that are easy to assess, measurable and subject to change or manipulation over time. These measures of success, which are often financial, can be benchmarked or compared to a company's peer group to give the business an idea of how its performance positions it in the race.

Benchmarking the financial performance of a business against that of its peers is an important aspect of running and growing a business. This white paper will discuss where to start the process of financial benchmarking, how to evaluate the data to be used, how to select which financial metrics to measure over time, and which resources can help with the process.

> *"Industry comparisons are a valuable part of understanding and improving business performance as they can point out areas that business owners need to take a look at and see why they are performing below the rest of the industry."*
>
> Chad Parker, Partner
> Sink, Gillmore & Gordon LLP

BENCHMARKING BEST PRACTICES

Where to start

The most difficult step in financial benchmarking is determining which data to use as a source for benchmarks. There may be some confusion as to whether a benchmark is either an *average for the industry* (a "C" on a school report card) or a *performance grade that businesses should shoot for* (an "A"). Depending on the data available, a business may benchmark using either standard, but typically a "benchmark" is the latter, the performance measure for which a business should strive.

When selecting benchmark data to use, remember these key characteristics:

1. **Accuracy** This may seem obvious, but benchmark data has to be trustworthy. Otherwise, analysis wouldn't produce meaningful insights. Be sure to evaluate the methodology used to collect benchmarks prior to implementation. Industry associations typically have benchmarks available for their industry, but first confirm that the association (1) is a good fit or an appropriate categorization of the business being analyzed and (2) has a large enough audience to provide a representative sample of the company's peer group.

2. **Timeliness** Some data sources, given collection methods, must present data with a lag time of a year or more. Data categorizing the events of 2011 may not be available, for example, until late 2012 if tax returns are a major resource. The race businesses run is real-time, and industries shift financially over the period of a year. Comparisons should likewise be as timely as possible. Especially if benchmark analysis is a once-per-year activity at the company—ensure that at least that one analysis isn't misleading or biased to past performance.

3. **Relevancy** Race conditions vary track to track. Similarly industries, geographies, and business sizes have very different trends and externalities to incorporate. One example might be a state government tax code change

that affects businesses in one state but not those in the adjacent areas. Or, the change could affect businesses of only a certain size, those with annual revenues over $5M. Perhaps a natural disaster—like Hurricane Irene's damage to coastal businesses—influences a company's performance for a given time period. In this case, it would be important to compare that company to other companies that fought Irene. This characteristic of benchmark data—relevancy—ensures it is an "apples to apples" comparison.

Resources

Where can a company find benchmark data that meets these criteria?

1. *Your accountant:* No longer can most accountants be justifiably called "bean counters." These financial professionals often times subscribe to financial information sources and can share benchmarks with business clients as well as advice on how to change performance relative to those benchmarks.
2. *Industry Associations:* For members, these organizations will often collect and publish benchmarks for that industry's financial and/or operational metrics such as a sales per seat in a restaurant.
3. *Small Business Development Centers:* Like accountants, these groups have tools on hand to guide young businesses and provide insight into industry performance.
4. *Other business owners:* Like-minded business owners that aren't in the same geographic market could both benefit from some information sharing including financial ratios or average costs as a percent of total revenue. Be careful to account for differences in costs of living, experience, market demand, etc.

BENCHMARKING BEST PRACTICES

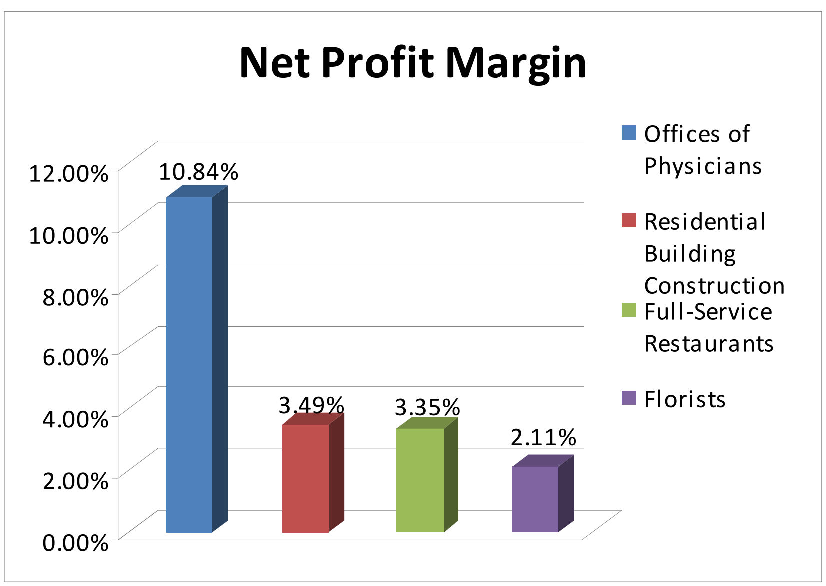
Where to focus

After an accurate, timely, and relevant data source is found, the trick becomes choosing which benchmarks, out of the sea of financial and operation metrics available, to focus on. Each business is unique and may have unique challenges that require additional benchmarks to be used and closely monitored over time. For example, a contractor may have large subcontractor expenditures. Are these expenses normal considering the contractor's sales volume? But, this section presents a list of financial metrics that are almost universally important to businesses and—when analyzed together—provide a quick and high-level review of a company's health. If an owner has traditionally focused on the cash balance in the bank, these metrics are an easy extension. The appendix includes a formula key, showing exactly how these and other financial metrics are calculated.

Also included with each type of ratio are private company industry data statistics based off data from the past twelve months. These are real-time averages rather than "benchmarks," so companies in these industries should aim to outperform these averages rather than meet them.

Net Profit Margin:

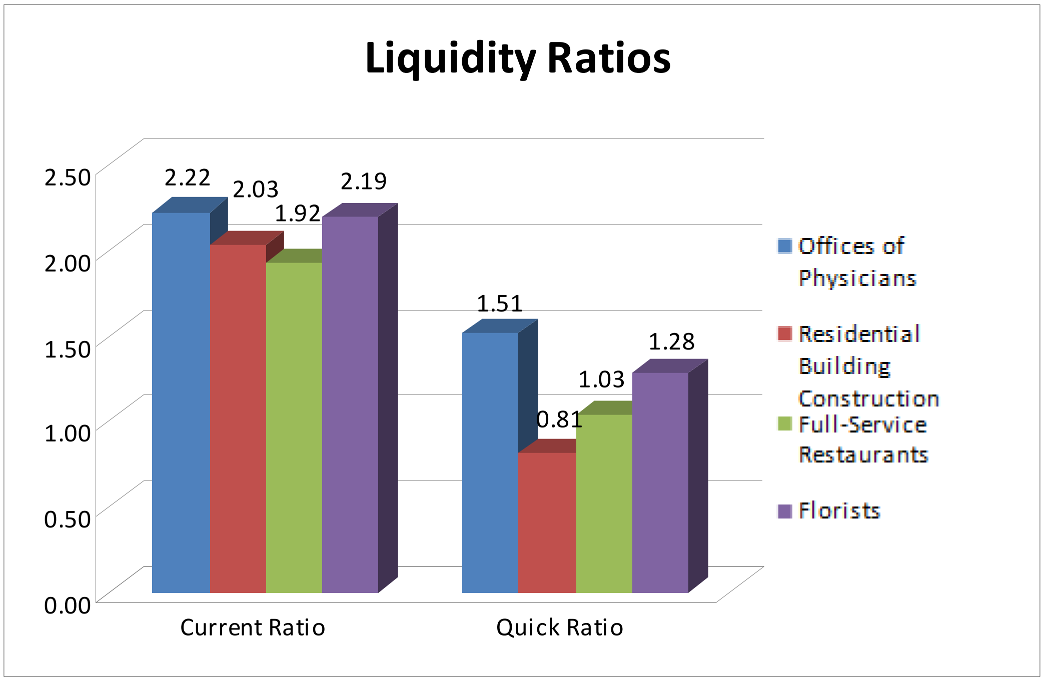
Net profit margin is generally expressed as net profit before taxes in a given financial period divided by sales. Another helpful interpretation is how many cents of profit a business extracts from each dollar it earns in revenue. This is a basic financial metric, but it is also *the most important*. If possible check raw financial data or the formula used by the data source to validate that it is consistent with the company's calculations.



The graph shows a few industries' averages for the past twelve months.

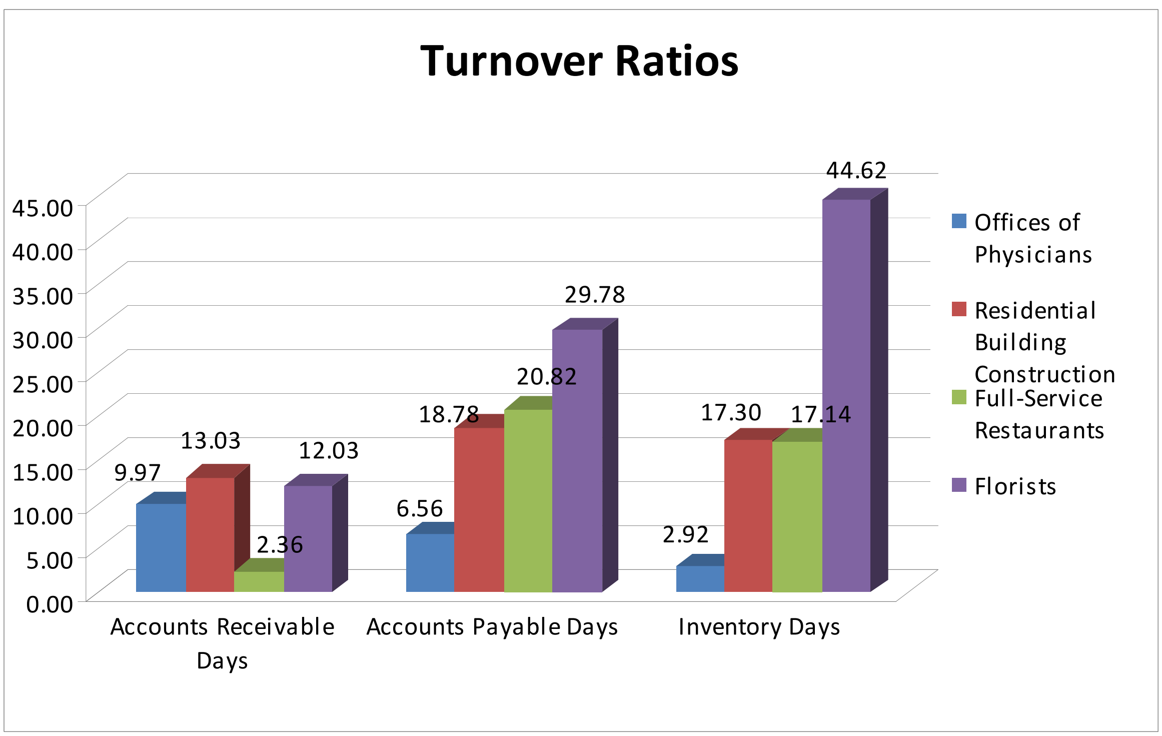
Liquidity Ratios:

There are two fundamental liquidity ratios that should be analyzed jointly. Current Ratio is expressed as current assets divided by current liabilities. This metric shows the company's general liquidity, but it has some limitations. For example, by including inventory in the calculation, it may provide a distorted understanding of the company's very short-term cash flow. The second liquidity ratio is the Quick Ratio, which is typically expressed as cash plus accounts receivables divided by current liabilities. Again, the Quick Ratio may not be perfect for gauging liquidity, but it is a useful and popular comparison to pair with the Current Ratio.



Turnover Ratios:

There are three fundamental turnover ratios to calculate. Accounts Receivable Turnover, in days, is expressed as accounts receivable divided by sales multiplied by 365 days. It roughly measures the number of days a company takes to turn accounts receivable into cash. Lower numbers are more desirable since it is better to have cash in the bank than extra accounts in the books. The second ratio, Accounts Payable Days, is expressed as accounts payable divided by cost of goods sold multiplied by 365 days. The Accounts Payable Days ratio indicates the number of days a company takes to pay its vendors. Here, higher numbers are better because it means the company is able to hold onto cash longer. The third turnover ratio, Inventory Days ratio, is expressed as inventory divided by cost of goods sold multiplied by 365 days. The Inventory Days ratio measures the number of days it takes to sell inventory, but it is very specific to the industry. Generally, lower numbers are better.



Resources

Pitfalls of Benchmarking and Tips for How to Avoid Them

⇒ *Comparing Company A to Company B:* Comparing one business to a peer group is helpful if the peer group is representative of the industry. However, if a company begins to compare itself to another, single company, there may be considerable differences that prevent a true comparison. For example, a new restaurant with new employees may not be as efficient as a restaurant that has operated in a similar market for thirty years. There are learning curves. Look critically at any benchmark analysis that restricts the sample size to one other company.

⇒ *Be careful with calculations and conclusions drawn from them:* The benchmarks discussed in this paper—net profit margin, liquidity ratios, and turnover ratios—are common in financial analysis, and their exact calculations are not generally refuted or changed. However, if a business expands their benchmark analysis to include industry-specific key performance indicators (KPIs) such as sales per seat, be sure to use the same calculation, period after period. If a subaccount is included for one period but then excluded in the next period's analysis, any trend analysis performed would be less meaningful and potentially misleading. Once definitions for the metrics are set (A list of common financial ratios and their calculations can be found in this paper's appendix), be sure that all members of management and the finance team have this set of definitions *and—more importantly—be sure they understand what the metrics mean*. This paper can be a starting point for the discussion.

⇒ *Assume that numbers and performance are always changing:* Positions in a horse race are constantly shifting: first to third, fourth to last, last to second, etc. An annual benchmark analysis really isn't sufficient because the industry is always changing even if your business isn't.

⇒ *Recognize that the benchmark analysis doesn't end with a variance report:* Even though it may seem that the work is complete once a company has its financial metrics compared to the benchmarks and variances calculated, the work is actually just beginning. But so are the opportunities. Each variance gives the financial executive a potential problem area to fix and the opportunity to improve the company's overall performance. Likewise,
the variance report will show in which areas the business is really

Formula Key

Appendix

Current Ratio = Total Current Assets / Total Current Liabilities

Quick Ratio = (Cash + Accounts Receivable) / Total Current Liabilities

Gross Profit Margin = Gross Profit / Sales

Net Profit Margin = Adjusted Net Profit before Taxes / Sales

Inventory Days = (Inventory / COGS) * 365

Accounts Receivable Days = (Accounts Receivable / Sales) * 365

Accounts Payable Days = (Accounts Payable / COGS) * 365

Interest Coverage Ratio = EBITDA / Interest Expense

Debt-to-Equity Ratio = Total Liabilities / Total Equity

Return on Equity = Net Income / Total Equity

Return on Assets = Net Income / Total Assets

Fixed Asset Turnover = Sales / Gross Fixed Assets

Sales per Employee = Sales / Total Employees (FTE)

Profit per Employee = Adjusted Net Profit before Taxes / Total Employees (FTE)

Profit Growth = (Current Period Adjusted Net Profit before Taxes - Prior Period Adjusted Net Profit Before Taxes) / Prior Period Adjusted Net Profit before Taxes

Sales Growth = (Current Period Sales - Prior Period Sales) / Prior Period Sales

Debt Service Coverage Ratio = EBITDA / (Prior Period CPLTD + Interest Expense)