Think Ahead ACCA

Guide from

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Key performance indicators

Identifying and monitoring key performance indicators helps you focus on the areas that really matter to your business.

Sales, cashflow and working capital are crucial for all businesses. But you also need to understand the key 'drivers' that have a major impact on the performance of your particular business.

1. Selecting information

There are a multitude of internal and external factors affecting the performance of every business. The sheer volume of information available to management can be a distraction.

You need to focus on a handful of key indicators

These should be indicators that:

- reflect the performance and progress of your business
- are measurable
- can be compared to a standard, such as a budget or last year's figures
- can be acted upon.

Most indicators are used to monitor and control profitability and cashflow

- The three key areas are sales, costs and working capital. Any trends towards cashflow problems or falling profitability will quickly show up in these figures.

Some indicators are used as part of a strategy to boost profitability and cashflow

- These are the drivers of the business, and they can be used to powerful effect.

Compare the past, present and future

- Figures for last year and last month provide hard facts and established patterns.
- Figures in budgets and forecasts help you to identify potential problems and opportunities early on.
- The figures must be calculated on a consistent basis.

Compare yourself with other businesses if possible

- Comparisons with competitors can be especially useful.

2. Sales

Enquiry levels provide early warning of any peaks or troughs in your sales

- Monitor where the enquiries come from, to establish which marketing campaigns work.
- If you have an established enquiry-to-sales ratio, and know the size of an average sale, you can use the enquiry level to forecast turnover.
- The number of new leads, or quotes given, can be similarly useful indicators.

Building up the order book is a key objective of most businesses

- The ‘order book cover’ figure compares the total value of your order book to breakeven sales for one month. A six-month order book means that you could break even over the next six months without making another sale.

When reviewing sales, monitor the figures that show what is happening

- Which categories of product are selling well?
- How are your priority products (those with the best margins and the best payment terms) selling?

- What has each salesperson achieved?
- Are your conversion rates (the ratio of leads to sales) changing?
- Enquiries, order book and sales progress should be reviewed by the sales team every week. At board level, they should be reviewed monthly.

3. Costs

Like sales, costs should ideally be tracked every week

- Many retailers are able to track them daily.
- Identify the key variable costs (eg materials) and what causes them to increase or decrease.

Maintaining a healthy gross profit margin is critically important

- Falling margins could result from any number of things: for example, higher input prices, a changed product mix, production inefficiencies and discounts.

Group different types of cost into cost centres

- For example, a warehousing and delivery business could split its direct costs into warehousing and delivery. Matching the costs against the revenue for each half of the business would show how profitable each operation is.
- Related overhead items (eg phone charges, postage and stationery) can be lumped together into one combined cost figure.

4. Working capital

Cash generation is a major priority for most businesses

- You control cash by controlling working capital – debtors, creditors, stock and work-in-progress.
- Establish how much extra working capital is required to fund each extra 10% increase in monthly sales. If sufficient finance is not available, you may need to delay (or reject) large orders.

- Cashflow (and credit control) should be reviewed every week. If this is a problem area, the review should be daily.

Produce an 'aged' list of debtors and creditors, every week

- This is an effective way to control debtors and creditors.
- Any customer payments that are overdue, suspect, or simply large should be highlighted and tracked.

Good stock control lets you release cash while still having enough stock available

- 'Stock turn' is the ratio of cost-of-sales to stock. If the figure decreases, find out why. For example, you may be purchasing stock that you cannot sell.
- The more you break down the stock figure into separate product categories, the easier it is to see where the problems are.

5. The signs were there

A sign manufacturer won a large order to make, deliver and install signs for a retail chain with branches throughout Europe.

Everyone worked frantically to fulfil the order.

The directors did not notice the falling profit margins, which resulted from the optimistic pricing of the delivery and installation elements of the contract (neither of which they had previous experience of).

Nor, until the crisis stage, did they properly think through the cashflow implications.

They were used to being paid promptly, 30 days after a sign left the factory gate. Now they had to wait until each sign was delivered, installed and inspected before they could even invoice for it.

Had the company used effective management information systems, they could have anticipated the problems that arose.

6. The power of drivers

Monitoring your sales, for example, will not necessarily help you improve your sales performance. By contrast, understanding the drivers behind the sales of your business can provide a breakthrough.

Different businesses will identify different drivers

For example:

- A management consultancy might find that man-hours sold per consultant per week is the key sales driver.
- A travel agency might find that staff turnover is a key driver, with experienced staff significantly outperforming new recruits (and without the extra costs of recruitment and training).
- An engineering company might find that the defect ratio is a key driver, with defects leading to goods being returned, extra work to rectify the faults, delays in payment, and lower prices being achieved.

Understanding the drivers helps you improve performance

For example:

- The management consultancy can monitor which consultants are earning the revenue, not only identifying the best performers but also changing attitudes.
- The travel agency might introduce a long-term incentive plan to help reduce staff turnover, alongside quarterly performance reviews.
- The engineering company might reorganise the workforce into ‘quality cells’ and replace unreliable machinery.

Drivers vary enormously

For example:

- sales leads in a capital goods business
- sales per square foot in a retail business

- market share in a market where only the big will survive
- machine downtime in a factory
- ‘first-time fix’ in a maintenance business
- the morale of employees in a nursing home.

Even direct competitors use different drivers to improve their performance

- For example, for some a prime location is important; for others, it’s not a key consideration.

7. Identifying your key drivers

What are the key factors which enable your business to outperform its competitors?

The questions you need to ask yourself are: What drives the sales figures? What drives the costs? What drives the cashflow?

For most businesses, the key drivers include major cost-efficiency items

- For example, two important drivers for a chicken processing company are inevitably going to be direct labour costs and yield (the weight of meat taken from each carcass). Both have a major impact on the gross margin.

Drivers often include ‘soft’ factors

- For example, effective networking (to build new business relationships) has proved to be the key driver for many newer businesses.

The measurement of drivers is sometimes indirect

- For example, if you have identified employee morale as a driver, you could monitor it by tracking voluntary overtime, absenteeism and sick days.

The drivers may change with time

- The growth of your business, changes in your market or simply seasonal changes may cause this.

8. Eye on the ball

Always come back to what drives your business. Take the example of a housebuilder.

The profitability and cashflow of housebuilders is greatly affected by housing prices and sales activity levels in that market. These in turn are affected by local demand and supply, and interest rates.

But it is all too easy for a housebuilder to ignore these key drivers. There will always be sites that are running over budget and other distractions.

Suddenly, the housebuilder may find that while he was busy building houses, the market for them has collapsed.

9. Presentation

Aim for management information that highlights the important trends

- You can achieve this by restricting the number of figures you monitor.
- The biggest breakthroughs are achieved by clever use of computer-generated graphs and charts. The trends instantly become clear.

Specify which figures you wish to review, and when

- Some figures need to be reviewed only once a year, as part of the annual budgeting cycle: for example, premises costs.
- Include 'red-light' systems, to alert you to a particular danger or opportunity that could arise.
- For some businesses, exception reporting is a useful method.

Specify how you would like the information presented

- A one-page summary sheet is advisable, backed up by detailed supporting information.

- The summary sheet could list the key performance indicators, such as total sales and gross margin, plus the top five drivers that you have identified. This forces you to concentrate on the issues that have the most impact on business performance.
- The information can be ordered according to functions: for example sales, production and finance.
- Always present the actual figures alongside the standard figures (eg the budget and prior year), so comparisons can be made.

Whoever prepares the information should include a written commentary

- This explains any important changes since the previous period, including the reasons behind them. For example, sales might be low because a particular contract has been delayed.

Special attention needs to be given to any major projects or new areas of business

- Problems usually arise. Identify them early on and take action immediately.

10. Action

Select the most urgent problems

- Identify the causes, and agree on the best cure for each.
- Agree which individual will be responsible for each action item, together with timescales. Record this in the minutes of the meeting.
- If the same problem keeps re-occurring, it is often a sign that the person responsible is not capable of doing the job properly.

Avoid being distracted

- Always come back to focus on the real drivers of the business.

Encourage your employees to sort out minor problems themselves

- If your employees know that you are closely monitoring the performance of the business, people will tend to sort out most minor problems immediately.

- You, the senior management, should therefore have more time and resources to focus on the more important issues.

Expert quotes

'If, like a management consultancy, your revenue is based on man-hours billed, do not put consultants' salaries in overheads. Put them in 'cost of sales', to show the true gross profit picture. *Paddy MccGwire, Cobalt Corporate Finance*

'The first step in closely managing a business is to provide yourself with a range of appropriate, accurate and timely information.' *Steve Richards, Gill*