Guide from

Clear House Accountants

Tel: [+44(0)2071172639] Email: [info@chacc.co.uk] [https://chacc.co.uk]
[Business Advisors and Accountants in London]

Key performance indicators

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

Sales, cash flow 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 organisation.

1. Selecting information

There's a multitude of internal and external factors that affect the performance of every business. The sheer volume of information available to management in the digital age 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 sales figures;
- can be acted upon.

Most indicators are used to monitor and control profitability and cash flow

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

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

- 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.
- Limited company reports and online industry whitepapers are goldmines of competitor information.

2. Sales

Enquiry levels provide early signs of peaks or troughs in your sales

- Monitor where the enquiries come from to establish which marketing campaigns are working.
- 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 delivered, can be similarly useful KPIs.

Building up the order book is a key objective for 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?
- How have autonomous sales performed (i.e. those delivered by an ecommerce platform)?
- 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

Just like sales, costs should ideally be tracked every week

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

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, rising cost of sale, production inefficiencies and discounts.

Group different types of cost into separate 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 (e.g. hardware fees, software costs and broadband charges) can probably be lumped together into one combined cost figure.

4. Working capital

Cash generation is a major priority for all 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.
- Cash flow (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 which are overdue, suspect, or simply large should be highlighted, tracked and addressed directly with the customer.

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 which you cannot sell.
- The more you break down the stock figure into separate product categories, the easier it is to identify where the problems lie.

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 didn’t notice the falling profit margins, which resulted from over-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 cash flow implications.

The business was used to being paid promptly, thirty 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 before they arose.

5. The power of drivers

Monitoring your sales will not necessarily help you improve your sales performance. By contrast, understanding the *drivers* behind the sales of your business will likely 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 ecommerce business may discover that delivery prices and turnarounds are key drivers, with expensive fees putting people off and long delivery times reducing customer retention;
- 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 by 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 ecommerce business may source a better courier contract that enables them to offer free delivery tiers and faster turnaround times;
- 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;
- sales per click-through in ecommerce;
- 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 isn’t even a consideration.

6. Identifying your key drivers

What are the key factors that enable your business to outperform the competition?

The questions you need to ask yourself are:

- What drives the sales figures?
- What drives the costs?
- What drives the cash flow?

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

- For example, two important drivers for an ecommerce business will be the cost of web hosting and the margins achieved through suppliers. Both will have a major impact on the gross margin.

Drivers often include ‘soft’ factors

- For example, effective networking (to build critical business partnerships) 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.

Eye on the ball

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

The profitability and cash flow 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's all too easy for a housebuilder to ignore these key drivers. There will always be sites which 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.

7. 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. With such tools, 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 which 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 KPIs, such as total sales and gross margin, plus the top five drivers you have identified. This forces you to concentrate on the issues which 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 often arise. Identify them early on and take action immediately.

8. Action

Select the most urgent problems

- Identify the causes, and agree on the best solution 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's often a sign that the person responsible is not capable of doing the job properly. Find out if there are training or mentoring requirements.

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 you are closely monitoring the performance of the business, they'll be more inclined to sort out the more minor problems immediately.
- As a member of the senior management team, you should have more time and resources to focus on the more important issues.

Signpost

- Find key performance indicator examples from Klipfolio.

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 McGwire, 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

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