

## Measuring for Success

By Joe Weston

As competition intensifies in any industry, the business analysis skills of owners and managers are at least as important as applied skills.

Imagine you are a frantic retailer whose busy season is now over and you are reflecting on the volume of merchandise sold and how successful the season has been. You may have a nagging concern that sales volume and the current year's profits do not tell the full story of the store's financial health. Or you may be feeling the pressure to improve the productivity of the business as you plan for less robust economic times.

You may have concerns whether you are doing the following:

- Building true financial strength and value for your business
- Generating profits sufficient for the resources you have invested in the company
- Falling behind your competitors, even though sales are increasing
- Building your product mix around high – or low – profit SKUs
- Positioning yourself to increase profitability without increasing sales

The biggest issue is how you can address your concerns and build a stronger financial future for your business.

Benchmarking is a proven approach for determining any retailer's competitive position and for setting its future course. Companies of all sizes began turning to business benchmarking in the early 1990s, using the basic principle that "you can't manage what you can't measure."

Of all the New Economy management ideas and tools from the early 1990s, benchmarking and strategic planning remain as the most popular and most frequently applied. These valuable management tools have stood the test of time because they lend themselves to continuous use and re-evaluation, with "continuous" being the key word. Creating steps to take action and improve performance must be a continuous effort or improvement will not be sustained. Benchmarking to guide your *future* improvements must also be consistent. Both tools require full involvement and buy-in from the entire management team or the effort will die quickly.

Whether or not we realize it, we benchmark all the time. Many of us begin the day with a casual benchmark from the morning paper: checking the baseball standings to see how our favorite team ranks against others. As a longtime fan of the St. Louis Cardinals, I have seen my share of bad news here. If your team is 10 games behind the first place team by the Fourth of July, you know your team is in trouble. You also know that two things must happen for the team to win the pennant: it must increase its winning percentage, and the team or teams ahead in the standings must lose more frequently.

Your team can control only the first option, but team management can project how many victories will be necessary to win the pennant by making assumptions about how many victories the other teams will have by the end of the season and comparing that with the current number of victories.

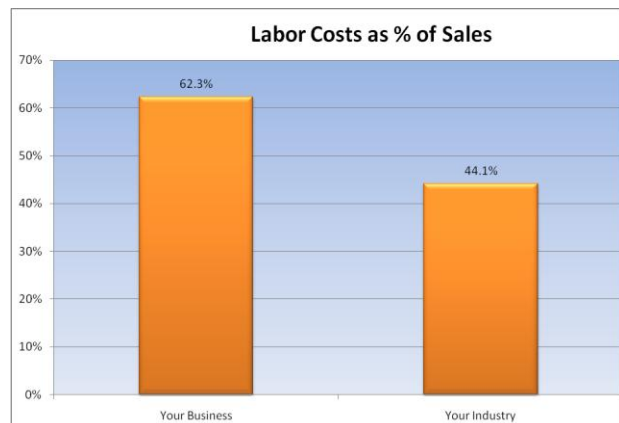
Once the target number of victories is set, the team must evaluate the strengths and weaknesses of its assets (players and coaches) and potential resources (revenue from sales and the owner's available wealth) to see if they are sufficient to win the pennant. Strengths must be leveraged and weaknesses addressed to achieve this objective. Remember, this whole series of events is driven by the team's overall performance benchmark, as expressed by the league standings. The team's strategic plan must be reviewed continuously to develop new actions if sufficient progress is not being made toward the goal.

Similarly, for your business to succeed in increasing competitive markets, you must be able to develop strategic plans for your business that consider your operation's relative strengths and weaknesses compared with those of the competition. This is the basis of business benchmarking.

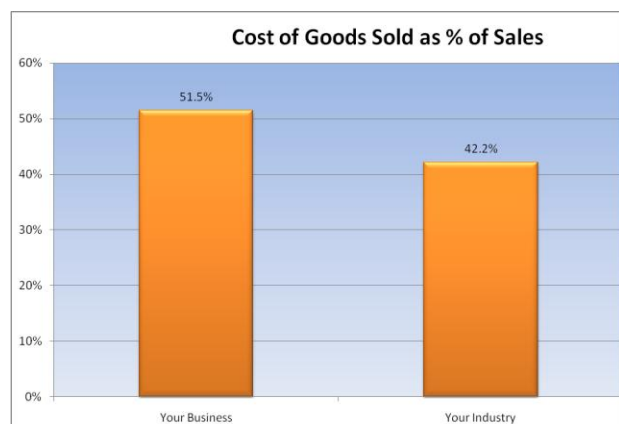
Effective business benchmarking involves continuous measuring and comparing of any performance metric so it can be improved over time. Anything that can be measured can be benchmarked, whether it is the number of shelf items sold, the number of man hours spent unloading trucks, the average collection period for receivables or average sales per salesperson.

Selecting the most important business variables for benchmarking requires careful planning by management, and the discipline to continue collecting data to monitor improvement over time. This practice may not always be popular with the staff but its value in building profit improvement is essential.

**1. Increased Productivity** – Your labor expenses, expressed as a percentage of sales, is higher than average for the industry (see graph, right). The potential culprits in this unfavorable benchmark comparison could be high wage rates, low sales or overstaffing. Once the benchmark indicates the need for change, you must put on your managerial hat, evaluate where the problem lies and take action to correct it.



**2. Reduced costs** – For your store, the cost of goods sold, also expressed as a percentage of sales, is higher than that industry average (see graph, right). This makes your gross profit percentage lower than average. Possible causes could be heavy discounting that lowered the average selling price of merchandise, higher than average supplier prices, high quality complaints and theft. A small change in gross profit percentage can create a significant change in net profit, so finding and correcting the cause of this problem is important.



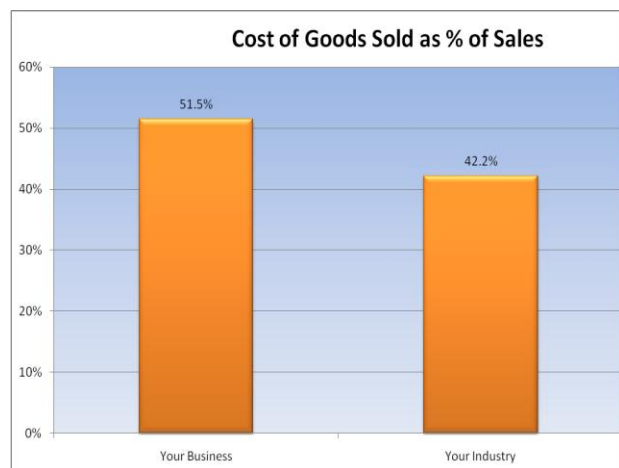
YOU MUST BE ABLE TO DEVELOP STRATEGIC PLANS FOR YOUR BUSINESS THAT ARE BASED ON IDENTIFYING YOUR OPERATION'S RELATIVE STRENGTHS AND WEAKNESSES COMPARED WITH THOSE OF THE COMPETITION.

**3. Improved quality of products and services.** Your company has a product warranty. However, the merchandise replacements you offer, as a percentage of sales, are costing you more than those of the rest of the industry (see graph, left). The need to replace defective merchandise can frequently harm your reputation with the customers and impact future sales.

What is causing the relatively high replacement experience? You could be carrying excess inventory that is difficult to maintain, labor staffing could be insufficient to continuously maintain the inventory, suppliers might be shipping substandard merchandise to you and so on. Correcting such problems protects your reputation among customers as well as future sales.

**4. Gap analysis for future planning.** The return on equity comparison suggests your equity (net worth) is not being effectively used to produce profit. Building equity is hard work in any business, and is the most important long-term measure of the financial health of your enterprise.

Low profitability can consume your company's equity value, while high profitability builds equity (see graph, right). Compare your current profits to your desired goal, and take action to close the gap between the two.



**5. Motivation for change.** Changing processes with which we're comfortable is difficult. Benchmarking helps quantify operating processes and takes the emotional factor out of the analysis. When faced with the need to change, managers can use benchmarking to see how and why such changes need to be made. Continuous benchmarking analysis allows managers to see emerging trends and anticipate the need for change before the problem gets to the crisis stage.

#### Types of benchmarking.

Benchmarking can be internal (comparing current performance with historical averages or projections) and external (comparing current performance with the rest of your industry). Both practices yield valuable management data needed for strategic planning – as long as benchmarking is done continuously.

**Internal benchmarking.** The first step is to take the mystery out of the concept of financial ratio analysis. Ratios are not difficult to calculate or to understand; they are developed using basic data from your balance sheet and income statement. Since most companies keep financial records from previous years, historical data can be used to create a retroactive ratio analysis that shows performance trends for the company in recent years.

Most ratios indicate how effectively the company is in using assets, debt and owners' equity to generate profit. Ratios such as return on assets (ROA) measure the effectiveness of asset utilization in generating profit. Your ROA is calculated by dividing net profit by total assets, and is expressed as a percentage value. A low percentage usually means profitability must be

increased to justify the current level of asset investment. On the other hand, if profit is at a reasonable level (as a percentage of sales), a low ROA percentage may mean that surplus assets could be liquidated and the proceeds invested elsewhere for greater return. Before any such liquidation, however, management should monitor the ROA trend for several years.

From historical financials, management can build a history of its financial performance with ratios, as well as compare the current key performance indicators to those of past years.

For real-time internal benchmarking, make a projection of the monthly flow of revenue and expenses that supports your annual sales and profit objectives. Then do as your baseball team does and compare each month's results to the projection to see if you are on target with your plan. If the actual results fall short of the projections, challenge the appropriate managers to develop steps to get performance back on track.

**External benchmarking.** Data for this important type of financial benchmarking can be difficult to find, but it is available from a variety of sources. Your accountant can provide guidance or may be able to help you find software that will perform industry comparisons for you. The Risk Management Association (RMA) formerly known as Robert Morris Associates is a database that contains financial benchmarks for thousands of companies in more than 700 North American Industry Classifications (NAICS) codes. These codes are developed by the U.S. Department of Commerce. Many libraries will have the current RMA *Annual Statement Studies*. You may find your industry's NAICS code at [www.naics.com](http://www.naics.com).

External operational and productivity benchmarks are often available through trade associations as a service to members. If your industry association does not provide such a service, ask them to consider doing so.

The association studies could measure key performance indicators as defined by the benchmarking participants. These customized studies combine financial data with operating processes and product mix to develop productivity measurements unique to the industry. All of these benchmarking techniques are focused on one goal: profit improvement. By using the data from carefully constructed benchmarking studies, business owners can build strategic plans that capitalize on competitive strengths and mitigate weaknesses.

An intuitive management touch is important in many businesses. But, as competition requires more insightful management, benchmarking adds a new element of management professionalism to companies of all sizes. Annual practice with benchmarking also makes developing comparison data easier and helps solve a wide range of problems.

Best wishes for success with profit improvement through business benchmarking!

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