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Introduction

EVERY DEPARTMENT IN EVERY business produces some kind of information that can be used by its manager to measure performance. This information may be related to operational considerations within the department, the financial condition of the entire company, or the performance of a company's suppliers and customers. Unfortunately, managers may not be aware of the multitude of measurements that can be used to track these different levels of performance or of the ways that these measurements can yield incorrect or misleading information.

This book is intended to help managers select the best possible set of measurements for a given situation. Chapters 2 through 14 itemize a series of performance measurements for different aspects of a company. Chapter 2 contains asset utilization measurements that can be used to determine a company's ability to sustain its sales, the level of asset and expense usage required to do so, and the sustainability of its current sales and expense levels. There are also specialized ratios that deal with such issues as sales returns, repairs and maintenance, fringe benefits, interest expense, and overhead rates.

Chapter 3 contains operating performance measurements, which describe an organization's operating performance in such areas as sales, gross margins, investment income, operating profit, and net profit.

Chapter 4 contains cash flow measurements, which are useful in determining the ability of a company's cash flows to keep it in business. These measurements should be used in conjunction with the liquidity measurements in Chapter 5, which focus on additional measurements related to cash flows, such as a company's ability to collect accounts receivable in an efficient manner, use its inventory within a short time, pay its accounts payable when due, and generally maintain a sufficient amount of liquid funds to pay off short-term liabilities. Chapter 6 contains capital structure and solvency measurements, which determine the relationship between a company's debt and equity, as well as the comparative proportions of different types of stock. It also addresses a company's ability to remain solvent and so can be used in conjunction with Chapters 4 and 5.

Chapter 7 contains return on investment measurements, which encompass net worth, several types of return on assets and equity, earnings per share, economic value added, and return on dividends. Chapter 8 addresses a company's financial market performance by describing such measurements as the price/earnings ratio, several variations on the stock options to common shares ratio, market value added, and the cost of capital.

Chapters 9 through 14 cover measurements for individual departments. These chapters are devoted to performance measurements for the accounting, engineering, human resources, logistics, production, and sales departments. In contrast to Chapters 2 through 8, which are devoted to measurements that are primarily used by the accounting and finance functions, Chapters 9 through 12 are more concerned with such issues as work capacity levels, efficiency, and effectiveness, which in many cases require no financial information at all. For example, measurements in Chapter 12, which deals with logistics, cover such topics as production schedule accuracy, on-time parts delivery percentage, and picking accuracy for assembled products.

Chapter 15 covers a variety of topics related to measurements using the Microsoft Excel electronic spreadsheet, including how to set up comprehensive sets of measurements that can be used for proportional, leverage, ratio, and trend analyses. It also covers a variety of spreadsheet formulas and report formats for forecasting, cash flow analysis, capital asset purchase analysis, interest compounding, investment analysis, and risk analysis.

The book concludes with an appendix and glossary. The appendix lists the names and formulations of every measure in the book, sorted by chapter. This list should only be used with the precautions given for them in their respective chapters to ensure their proper use. The glossary covers the definitions of the terms found in many of the measurements listed in this book, to clarify the exact types of information needed.

The chapters containing measurements (Chapters 2 through 14) are all structured identically. Each begins with a table that lists the measurements described in it, which one can use to quickly access a needed calculation. Thereafter, each chapter is broken down into the discussions of individual measurements. Within each measurement section there is a description, formula, example, and discussion of cautionary items. The description typically notes how the measurement is used and who uses it. The formula shows any variations on the calculation and what types of data to include or exclude from it. The example is generally a complete scenario that describes how the measurement is used in a simulated business situation. Finally, any cautionary items are noted; these can include the ways in which the measurement can be altered to yield incorrect results, or what other measurement should be used with it in order to yield a more comprehensive set of information.

The reader may use this book to search for a single calculation, which can be used for highly targeted needs. However, a better approach is to peruse the entire book, with the objective of developing a complete set of measurements that will yield a more comprehensive view of a company's entire operating and financial situation. For example, a CFO might be interested in a company's stock market performance and therefore watch only the price/earnings ratio. This single measurement, however, focuses only on the perception of investors with regard to a company's future earnings potential. A more

rounded set of measurements might include the days of sales backlog (since it indicates future changes in sales volume), production capacity utilization (since it shows the ability of the company to produce its incoming sales), and the days of accounts receivable (since it shows the company's ability to convert sales into cash). The exact set of measurements will change in accordance with a company's industry, size, operational configuration, and degree of financial leverage, but one issue will remain the same: A single measurement is not enough to yield a clear view of a company's financial and operating condition.

Many of the ratios in this book are of the nonfinancial variety, such as mean time between failures, the science linkage index, and the quote to close ratio. Managers have a difficult time creating a linkage between these nonfinancial measures and improvement. A common result is for managers to impose a broad range of nonfinancial measurements upon a company, hoping that some behavior changes will result in improved financial performance. A better approach is to conduct a detailed review of the financial performance drivers of a business, and to only measure the results of nonfinancial measurements that are likely to have a direct impact on those financial measures. For example, a consulting business is experiencing significant delays in the completion of customer projects, which delays revenue generation; the delays are caused by a high level of employee turnover, requiring long lead times to bring in qualified replacement staff. Thus, a reasonable nonfinancial measurement in this case is the annual employee turnover percentage, since there is a direct linkage between it and revenue generation.

Once nonfinancial measurements are selected, be sure to verify that improvements in the activities being measured are actually resulting in altered financial performance. There is often merely an assumption that enhancements to a nonfinancial activity will improve financial performance, but no one has actually tested the assumption. This verification step will ensure that measures that do not assist in improving financial results are thrown out.

A major problem with measurement systems is inconsistency of application. If a company has multiple locations, then it must have a system in place for ensuring that the same measure is calculated in exactly the same way in every location. Local managers can be quite skilled at tweaking measurement systems to reveal the best possible results, frequently by excluding some data from measurements, altering the date ranges over which data is collected, or altering the measurements themselves. This issue can be monitored through the use of occasional internal audits, or with centralized measurement systems that keep local managers from being involved in the measurement process.

Even if a company has developed a reasonable set of measurements, this does not mean that they should never be changed. On the contrary, measured items will generally garner a great deal of management attention and then improve to the point at which they no longer change—thereby resulting in a stale set of measurements. For example, inventory accuracy can improve only to 100%. At that point, the measurement is needed on a monitoring basis to ensure that it does not degrade, while a new measurement can be created to be the focus of corporate attention. However, there will be a few measurements, usually involving sales levels and break-even points, that will always be the centerpiece of any measurement system, since they bring attention to

bear on the most crucial revenue and cost elements of the business. Thus, a properly designed measurement system should include a few key items that will be constant for many years, accompanied by other measures that are used for internal improvement purposes and will change in concert with corporate objectives.

A final warning: Do not become so enamored of measurement systems that you burden the company with a wild profusion of measurements that track every conceivable activity, since this causes several problems. First, no one knows which of the measures are most useful for tracking the company's ability to achieve its mission. Therefore, they try to perform well under *all* of the measures, resulting in resources being allocated to the improvement of some measures that have no bearing on financial performance. Second, employees may engage in irrational behavior in order to achieve high scores through the measurement system, even if they must downgrade their performance in areas not being measured.

This book is filled with almost 250 financial and operational measurements that have proven to be of considerable use to the author in tracking the performance of many companies in a variety of industries. If you would like to see other measurements in the next edition of this book, please send your request to the author at bragg.steven@gmail.com.