



# kendons

CHARTERED ACCOUNTANTS

## YOU & YOUR REVIEW OF PERFORMANCE

One of a series of business  
advisory publications  
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The information presented in this brochure is necessarily of a general nature and should not be relied upon as a substitute for specific advice. For advice on, or assistance with any of the matters raised please contact:

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## Evaluating Business Financial Health

The success or otherwise of a business is dependent upon two things:

A viable Core Business  
Management

- How often do you start your day intending to FAIL?
- How often do you start your day UNDECIDED?
- How often do you start your day intending to SUCCEED?
- How often do you prefer to stay in BED?

Why do 50% of companies fail within 5 years if most people intend to succeed?

Management fails because of:

- Poor Quality Information
- Poor Observation Skills
- Poor Judgement
- Denial of problems and Procrastination: “failure to put the right people in the right jobs – and related failure to fix people problems in time”
- Little discussion with employees about strategy
- “Bad Execution” such as:
  - not getting things done
  - being indecisive
  - not delivering on commitments

## What are the Key Measurements?

Before an objective review can be carried out it is necessary to calculate the relevant ratios and percentages of the key items to be reviewed. Some of these are:

1. **Gross Profit Margin** is the gross profit per \$ of sales expressed as a %.
2. **Net Profit Margin** is the net profit per \$ of sales expressed as a %.

3. **Total Asset Turnover** is the number of times per annum assets are turned over and it reflects how efficiently the assets are being worked. For a given net profit margin the higher the rate of asset turnover the higher the Return on Investment. Other things being equal, a decline in asset turnover is usually associated with a worsening cash position.

However, it may have arisen because of new plant and equipment purchases indicating a capacity expansion. If this is the case you would be looking to future increases in sales volume to restore this aspect of profitability.

4. **Non-current Asset Turnover** reflects the productivity of the fixed/tangible assets used in the business. To the extent that there is idle capacity you would expect the turnover of non-current assets to increase with subsequent increases in sales revenue.

Evidence of a decline over time should be viewed with concern and you should consider the possibility of selling off unproductive assets.

5. **Stock & WIP Turnover** shows the average number of days it has taken to turn stock into cash.

Strictly speaking it should be based on average stock levels but it is sometimes based on closing stock. It is calculated as stock divided by cost of goods sold multiplied by 365 (days). In the case of professional service firms WIP/turnover is calculated by reference to total fees.

A higher rate of stock turn (ie fewer days) will improve liquidity. The thing to look for is slow moving products (jobs). This requires detailed analysis. It is also useful to look at the business's billing procedures.

6. **Debtors' Collection Rate** shows the average number of days debtors take to pay their accounts. This is based on average or closing debtors. It reflects the business's credit control policy. Don't be afraid to lose customers simply because you enforce a tight credit policy.

7. **Payables Payment Time** shows the average number of days taken to pay creditors. Only trading stock creditors and/or creditors in relation to materials or services that comprise the cost of goods/services sold are included. Payables payment time will not be calculated for professional service firms.
8. **Net Working Capital Turnover** shows the net number of days outstanding in debtors and stock (& WIP) after allowing for outstanding creditors. Gross working capital is the total days tied up in debtors and stock. It represents the length of time taken for cash to return to cash.
9. **Cash Sales Ratio** shows the percentage of total sales that are cash sales. A higher ratio will obviously improve liquidity. If the information is available, credit card sales would be included as part of cash sales.
10. **Cash Flow per Sales \$** is a ballpark indication of the cash available from each \$ of sales after allowing for additional stock and debtors. If sales are increasing and this is accompanied by increased levels of debtors and stock then a portion of each sales \$ will be required to fund these assets and will not therefore be available to meet other commitments.
11. **Operating Cash Flow per \$ Total Debt** is an important indicator of potential liquidity problems. Operating cash flow is defined as net profit after adding back non-cash expenses (depreciation) and is adjusted for the change in current assets. Total debt includes all external borrowings. A downward trend in this ratio should be viewed with concern.
12. **Sales per \$ Team Wages** is a measure of productivity from the viewpoint of the cost of your team. A decline in this ratio indicates that wages are increasing at a faster rate than sales revenue and is an indication that sales productivity needs to be addressed and/or prices need to be looked at. It is a particularly important ratio where wages represent a high proportion of total expenses.
13. **Sales per Equivalent Full Time Person Employed** is another measure of labour productivity. All people in the organisation should be included.

14. **Finance Cost as % Profit Before Interest** is an indication of the firms exposure to financial risk and the extent to which debt is relied upon. In a loss situation this ratio is meaningless but obviously the business has a problem that needs to be addressed.
15. **External Debt as % Total Assets** shows the extent to which business assets are financed by external borrowings. It is called the degree of financial leverage. It's not possible to say what an acceptable level of financial leverage should be because it will vary from one business to the next. What can be said, however, is that the higher the ratio the greater the risk (also see ratio 14).

When looking at this ratio the trend is more important than the absolute degree of leverage.

If it is increasing over time it may indicate that insufficient funds are being retained to finance the growth of the business. This will generally be reflected by an increase in the proportion of short term debt.

It is also important to consider what types of assets are involved. For example, if the bulk of assets are highly liquid (such as cash, investment deposits, debtors and, to a lesser extent, stock) a higher ratio would be acceptable than if the assets are dominated by plant and equipment, intangibles and property.

The term of the debt is also relevant. As a general rule, long term debt should be used to finance long term assets. A high degree of financial leverage accompanied by a high proportion of short term debt reflects greater financial vulnerability.

Short term debt coverage is reflected by the ratio of current assets to current liabilities and should be looked at in the context of the efficiency of working capital management (see ratios 4 to 9). This ratio should always be greater than 100% - preferably in the 150% - 200% range.

16. **Sales Required to Break Even** is the sales revenue at which the business makes neither a profit nor a loss given the Gross Margin (GM) % and total expenses. In calculating the break even sales revenue, other income is netted against total expenses. The break even sales point will fall as the GM% increases or fixed costs fall.

The margin of safety shows the % amount by which sales would have to fall before the firm would just break even but remember this assumes total overhead expenses do not change.

17. **Statement of Sources and Uses of Funds** is a quick form of funds statement, which shows where the funds the business has obtained have come from and what they have been used for. It also shows why the profit and other sources of funds are not necessarily in the business bank account. The funds may have been used to purchase assets or repay debt (to name just two). If 'Uses' total more than 'Sources', then the net worth of the business has fallen. What is net worth? It is the proprietor's wealth invested in the business. Net worth is also called residual equity.

Residual equity is a term accountants use to mean the business owner's share of the book value of the net assets (ie the \$ portion of the value of the business when Total Liabilities are deducted from Total Assets). Whether you would actually get this much if you disposed of the business as a whole, or the assets separately, obviously depends on market values. You may end up with more or less.

18. **Gross Trading Receipts** is Sales plus GST plus Last Year's Accounts Receivable balance minus This Year's Accounts Receivable balance.

## **Trends and Inter-business Comparisons**

It is the trends in these figures, ratios and percentages which are important to the analyst in assessing the health of a business. Deteriorating trends must be addressed quickly and decisively.

A further comparison, which can be extremely valuable, is a comparison of your business results and ratios with other similar businesses.

For many businesses there are industry standards for many of the ratios and percentages calculated.

Kendons has access to national providers of results and statistics which can assist greatly in measuring and comparing performance.

### ***The Importance of Consistency***

If comparisons over a period of time are to be valid, it is important that the financial figures are prepared on a consistent basis or, if a change is made, the fact of that change and the quantitative effect is known. The validity of interbusiness comparison is dependent upon the methods of reporting being consistent between enterprises and therefore great caution must be exercised in making interbusiness comparisons. Comparisons with established targets based on the results of the business under review and similar businesses are of greater certainty.

## **Comparative Performance Review**

Performance review can be considered under general headings which reflect their relationships to the business structure:

- Operational Performance
- Use of Resources
- Control of Financial Structure

To assist you in determining the health of a business and in setting the direction in which it should go the following questions are posed:

### ***Analysing Operational Performance***

#### *Profit*

How did we perform in meeting our gross and net profit goals?

What action do we need to take to maintain or improve this result?

### *Return*

Is the business providing an adequate return on the capital employed?

What alternatives do we have?

What actions should we take?

### *Efficiency*

Are expenses too high?

How productive are staff?

How does the business compare with similar businesses or best practice?

## ***Analysing Use of Resources***

### *Productivity*

Are staff generating enough revenue per \$ of cost?

Is the business generating enough income per square metre of space?

### *Stock Control*

Is the stock level appropriate?

Is it generating enough Gross Profit?

### *Debtors Control*

How many days does it take to collect receivables?

What % is over 60 days?

### *Return on Assets*

Could I make more money by investing the same amount in some other way?

## ***Control of Financial Structure***

What is the average level of working capital?

How does that compare with similar businesses?

What is the equity level?

Is that too high or too low?

## Introduction to the Kendons Performance Analysis

The Kendons performance analysis sets out the relevant financial details and gives ratios and percentages to enable review.

Remember that the accounts must have been prepared on a consistent basis to provide a meaningful comparison and it is historical information only.

More important is a comparison between current information and targets, and of trends.

A review of trends highlights strengths and weaknesses over a time period.

- Are net profit and sales rising?
- Is the current ratio remaining steady?
- Is age of debts changing? Improving? Getting worse?
- Are expenses being controlled?

In some cases the simple comparison of current year's results with prior year and targets will be sufficient to identify the problem and indicate the action to be taken to correct it. In other cases experience and knowledge of the industry and the firm will be necessary to enable judgement and **commonsense** to be applied. Remember that the analysis should be objective but the conclusions drawn from it will be subjective.

### ***Review Statistics***

When reviewing accounts it is important to remember the **Principle of Exception** – it is better to draw attention to unsatisfactory features and suggest ways in which they can be rectified than to devote a report or analysis to those factors that are satisfactory.

There are a number of ratios and percentages that can be calculated, but some are of more value than others.

There are also, in certain cases, different approaches to calculating the ratios. It doesn't matter which approach is used provided it is consistently applied.

## Profit Analysis

- *Gross Profit Percentage/Margin*

$GP/Sales \times 100$

A declining margin can arise because variable costs have risen faster than prices, or prices have been reduced without a corresponding reduction in the costs of products.

It is a good idea to frequently review the gross margin for each product or product group but don't eliminate the low margin (%) products until you have thoroughly satisfied yourself that you have properly accounted for costs.

You often find, particularly in manufacturing and service firms, that the true costs of production have not been charged to the right products and what appears to be a high profit margin line is in fact a poor performer and vice versa. One way to confirm this is by means of an activity based cost analysis.

A fall in Gross Margin percentage may not reflect poor management. Eg:

- Need to meet increased competition may necessitate lower mark-up.
- A reduction in mark-up as deliberate policy in hope of increasing sales. A lower GP per unit on higher T/O may increase both the GP and NP.

Stock Cost	\$ 1,000	\$ 1,000
Mark-up	25% <u>250</u>	20% <u>200</u>
Sale Price	1,250	1,200
Units Sold	20	26
Total Sales	25,000	31,200
COS	<u>20,000</u>	<u>26,000</u>
GP	<u>5,000</u>	<u>5,200</u>

- Change in product mix to lower margin lines.

Where an unsatisfactory Gross Profit Percentage cannot be explained by the factors above, further investigation should take place.

The following possibilities may be the cause:

- Inaccurate stocktake due to cut-off errors.
- Inaccurate stock count, errors on addition, omission of sheets.
- Failure to charge sales due to inefficient accounting system.
- Pilfering.
- Excessive mark-downs to generate more sales.
- Error in last year's stocktake.
- Goods for own use not accounted for.

Similarly, an overstated margin can arise from stocktaking and accounting errors.

- *Percentages of Expenses to Sales*
  - The comparison can be tailored to individual needs.
  - Care should be taken in reading too much into figures.
  - Direct costs will fluctuate in relation to sales volumes while fixed costs will remain relatively constant in \$ terms. Similarly the percentage of Direct Costs to Turnover should remain relative constant while the percentage of fixed assets to turnover will reduce as turnover increases.

Eg: On increased turnover, the % to sales will reduce on fixed overheads such as rent.

Also where "other overheads" fluctuates significantly, it may be more relevant to analyse the significant item affecting the calculation.

- *Net Profit as Percentage of Sales/Net Profit Margin*

For companies allocating shareholders salaries, Shareholders Salaries and Net Profit before Tax as % of Sales is a more relevant figure.

The percentage is an indication of general managerial efficiency.

If an undesirable trend is evident (ie decreasing % over time) the GM and Expense % should be investigated to find out the cause of any change. Obviously, it will involve an analysis of the gross profit margin to identify price or variable cost problems and you need to look at your other costs relative to your sales.

Analysis of the increase (decrease) in Net Profit shows the impact of sales volume, gross margin, expenses and other income on the change in profit between the previous and current periods. This analysis is one of the most important parts of the review because it highlights the critical importance of focusing on margin as well as volume and cost control.

For example, a business that seeks to build sales by heavy discounting will inevitably see a big positive contribution from the volume effect but this can be totally wiped out by the lower gross margin per \$ of sales.

Furthermore, the additional sales volume almost always results in cost creep so expenses frequently rise at an equal or sometimes faster rate than sales.

Note: The effect on NP of the change in Sales Volume is NOT the change in total sales revenue. It is the change in sales revenue multiplied by the current period gross margin %. It shows the impact of a change in the volume of sales on the gross profit.

Similarly, the change in Gross Margin is NOT the change in total gross profit. It is the change in the Gross Margin % multiplied by sales. If you could consider last period's sales as your starting point then a drop in price, an increase in variable cost or a change in sales mix that results in a Gross Margin % decline will not only have affected any additional sales you may have won but will also have eroded the profit you should have expected if sales levels had remained unchanged.

### ***Control of Resource Use***

Ratios and % considered under this heading reflect on the financial stability of a business, ie the likelihood of it remaining a continuing entity.

### *Rate of Stock Turn*

*(Cost of Sales/Average Stock Carried)*

- A slow turnover may be indicative of inefficient use of funds and a resulting liquidity problem.
- Care should be taken in rating any Stock Turn rate as good, satisfactory or bad. Comments should have regard to trend and what is looked upon as normal for business/class of stock.
- If year-end stock figures are abnormal due to seasonal nature of business, a monthly average is preferable.
- Stock turn can be misleading when looking at an overall figure for a business. For example, a stock turn rate of 2 for the whole stock may be the net result of half the stock being turned over 4 times and the other half not moving at all.

A product line with a low profit margin which is turned over rapidly may make a greater contribution to gross profit than another line which turns over slowly but for which there is a greater profit margin, even though the same amount of capital is invested in each.

Example:

	<u>Line 1</u>	<u>Line 2</u>
Cost per Article	\$10	\$10
Mark-up %	50	25
Selling Price per Article	\$15	\$12.50
Average Value of Stock (at cost)	\$1,000	\$1,000
Turnover Rate	4	10
Cost of Sales	\$4,000	\$10,000
Sales	\$6,000	\$12,500
Gross Profit	\$2,000	\$2,500
Gross Profit Margin %	33.33	20

### *Average Age of Debts (in days)*

*(Debtors at Year End/Credit Sales for Year) x 365*

- Indicates promptness of payment and the effectiveness of the credit policy of the business.

### *Accounts Payable days Credit*

*(Accounts Payable/Direct costs plus overheads excluding depreciation interest and rent) x 365*

### *Plant Age*

*(Cost less Accumulated Depreciation/Cost (excludes Land and Buildings))*

### *Control of Financial Structures*

#### *Current Ratio*

- The test of solvency, ie the ability of the business to meet current obligations.  
*(Current Assets/Current Liabilities)*  
The ratio excludes shareholders' Current Accounts (Kendons Performance Analysis).  
Normally it is desirable that current assets exceed current liabilities and the greater the margin, the more secure the financial position.
- **But** too high a ratio may mean the best use is not being made of the funds.
- If the ratio is too low, the ability to build up stock and to extend credit is limited.
- It is the trend that is important

#### *Window Dressing*

- Letting stocks run down before balance date.
- Deferring purchases of Fixed Assets until after balance date.
- Selling marketable securities before balance date.

All improve the current ratio calculation without improving the financial position of the business.

#### *Quick Asset Ratio (Liquidity Ratio)*

- This ratio is regarded as a better test of solvency because it eliminates stock that may not be readily realisable.  
*(Current Assets less Stock, Prepayments & Shareholders Advances/Current Liabilities less current portion of term debt and shareholders' and associated parties' liability)*

### *Shareholders' Equity/Proprietary Ratio*

- Indicates the extent to which shareholders are financing the business.

$$(Proprietors\ Funds / Total\ Funds) \times 100$$

There is a body of opinion that considers equity ratio should not fall below 50% but, generally speaking, any rule of thumb method is unwise and financial structure and earnings must be looked at.

- Maintaining the optimum balance between internal and external debt requires management skills.

*External Interest*      All interest except that paid to Shareholders and Directors

*Return on Equity*      Total Return before Tax ÷ Equity in business

*EBIT on Funds (ROCE) where:*

EBIT = Earnings Before Interest and Tax

ROCE = Return On Capital Employed

EBIT ÷ Net Assets (calculated as total Assets less Current Liabilities excluding current portion of Term Liabilities, shareholders' and related parties' current accounts)

### *Under/Over Capitalisation*

Under capitalisation – insufficient funds contributed by shareholders to finance adequate fixed assets and to provide sufficient working capital.

- Indicated by low current ratio, low shareholders' equity ratio and high sales to shareholders' funds.

Apart from danger of liquidation, under-capitalisation may affect profitability through:

- Loss of cash discounts.
- Inability to take advantage of quantity discounts.
- High interest payment.
- Retention of inefficient plant.

It results in reliance on banks and creditors to provide finance to supplement the inadequate capital.

Again, the trend may highlight a problem, eg a current ratio reducing over time may indicate a problem which would be resolved by the injection of additional capital.

Over-capitalisation is equally undesirable. Funds contributed by shareholders are not being used efficiently and earnings on those funds are low – better to withdraw some money and invest it elsewhere.

## **Early Warning Signs**

An effective review of financial and operating data looking for the early warning signs will identify problems before they become acute and allow corrective action to be taken.

There are hundreds of warning signs.

Their importance varies depending on:

- The industry
- The point in the business cycle
- The point on the firm's life cycle curve
- Their predictive ability
- Their lead-time.

### ***Early Warning Signs***

The following is a list of early warning signs, which you should use in assessing the health of a business. Although comprehensive, it is not a definitive list:

1. A falling gross profit margin.
2. Increasing expense percentages.
3. Peak overdraft in excess of 2 months turnover.
4. Debt servicing ratio climbing.
5. Replacement plant always needing to be funded with hire purchase.
6. Personal expenditure more than 50% of net profit after interest.

7. Changes in industry position.
8. Decline in market or market share.
9. Pressure on price.
10. Increasing stock and work in progress.
11. Increasing debtors to sales.

## Summary

Finally in summary, our experience is that success comes to those who have:

- Common Sense
- Persistence
- Motivation
- Willingness to Work
- Single-mindedness.

Successful businesses are those run by people who:

- Plan
- Measure the risks
- Adapt
- And, if it is going to plan, Persist

A high gross income gives flexibility. Low fixed costs reduce risks. A worthwhile return generates cash. Cash is essential for survival, growth, just about everything. Planning means you can identify the risks and ensure that they are compensated.

Measuring results is an essential part of the whole process but to be of any use the measurements must be:

- Timely
- Meaningful
- And Capable of being Acted Upon.

The data must be understood and it must be within the Manager's power to do something with it.

*Please contact us for your copy of one of our other Business Advisory Publications, or download them from our website free of charge at [www.kendons.co.nz](http://www.kendons.co.nz).*

*You and Your Bankers*

*You and Your Business Acquisition*

*You and Your Business Plan*

*You and Your Records*

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