



Explanation of :  
Key Performance Indicators For

# THE FINANCIAL<sup>®</sup> Fence



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## Introduction

One of the ways to bring the numbers of a business into context and make them more easily understood is to have a set of indicators which help you do that. In The Financial Fence® we have a total of eleven indicators, which fall into three categories. (Note: The free version of The Financial Fence® shows seven key performance Indicators).

Following is an explanation of each of the eleven Key Performance Indicators(KPI's).

## CATEGORY 1 –THE KEY TOP LEVEL MEASURE

### 1. Return on Capital (EBIT to Total Capital)

(EBIT is Earnings Before Interest and Tax)

*Formula is:  $EBIT$  divided by  $Total\ Capital\ Employed$  expressed as a percentage*

*The purpose of this KPI is to relate the overall profit 'FOR THE PERIOD' with the overall Total Capital Employed at the BEGINNING and the END. It's the key indicator for the overall performance of the business, as it takes into account ALL of the profit and ALL of the Capital Employed.*

The overall capital in your business should match the level of activity in your business. This KPI includes both activity (Return) and investment (Capital). Many business people focus almost solely on addressing the level of profitability in the business and while this can have a significant affect on the business performance. It is only one driver. Having the correct amount of capital invested in the business is also vitally important to achieving high levels of sustainable performance.

Where a business has too much capital for its level of activity, its performance will be reduced through inefficiency and equally, where a business has too little capital, its performance will also be reduced because it will have insufficient resources to perform effectively.

We look to see a return on capital (ROC) at 40% or better. We would consider 25% to be at the lower end of an acceptable range, while returns in excess of 100% would indicate the business may have insufficient capital to enable sustainable growth over the medium to long term.

## **CATEGORY 2 - ACTIVITIES OF THE BUSINESS**

These KPI's measure how the operational activity in your business can be presented in financial terms, e.g. what is the financial result of interacting with your clients or customers.

### **2. Interaction with Customers - Contribution Margin**

*Formula is: Contribution Margin divided by the Sales expressed as a percentage.*

*This is the KPI which determines the contribution you get from your interaction with your customers. It measures the contribution a sale makes towards your infrastructure expense and profitability. This KPI must be greater than your infrastructure costs to sales KPI for your business to be profitable.*

The contribution to profit your business achieves from interacting with customers is a critical measure for your business. If your business is not making sufficient profit at this point it will not be able to generate sufficient net profits to be sustainable over time.

It is also very important that this KPI is measured correctly and traditional accounting methods normally fail to do this because the only costs they include at this level are the direct costs of physical products sold.

To accurately measure your performance when interacting with customers we include all cost items that are relevant to this activity in your business. This will include such items as: costs of acquiring products for sale, lead generation costs, sales related costs (such as commission and sales persons wages), and all other costs directly related to acquiring and distributing your products and services. For most small to medium business of particular importance is the inclusion, at the correct market value, of the time working business owners devote to interacting with customers.

As many business owners fail to remunerate themselves at the true market value for the services they deliver to their business, this item of cost needs to be looked at carefully to get an accurate assessment of your business performance.

We look to see a contribution margin in the 20% to 40% range. When this margin is too high there is usually insufficient investment being made in servicing and growing the customer base, (or not all cost actually being incurred have been identified) and when it is too low it is often an indication that the pricing/costing process of the business needs review.

### 3. Infrastructure Expenses to Sales

*Formula is: Expenses divided by the Sales expressed as a percentage.*

*This is the KPI which determines the amount of each sales dollar that you need to cover your infrastructure expenses (before tax and interest). Your business will be at breakeven when this KPI is the same as your contribution margin KPI.*

This KPI shows you the level of infrastructure (often referred to as overheads) that your business is incurring. These are the costs that you incur, just by being in business, regardless of the level of activity that you have interacting with customers. This indicator gives you a measure of how well you are administering your business and how efficient you are in supplying your business with items like essential services, communications technology and premises for example.

In the long term it is important to keep these costs at a level which is in line with your business activity to ensure your sales and operational functions are adequately and efficiently serviced.

We look to see an infrastructure to sales indicator in the 10% to 20% range. When this indicator is too high it is a sign of inefficiency in the overhead cost structure of the business. When it is too low it is an indication that the business may be under resourced in support services which will in turn limit growth and performance in other areas of the business.

### 4. EBIT (Earnings Before Interest and Tax) to Sales

*Formula is: EBIT divided by the Sales expressed as a percentage.*

*This is the KPI which determines the overall quality of your trading activity. Whilst a business can make losses for a period and still survive, it cannot continually do this. This KPI tells you how much profit is left for each dollar of sales that is made.*

EBIT is the key measure of overall profit performance in terms of business operations (including support and service functions). It is important because it shows you how your business is performing before any distortions from the way the business has been funded and from any taxation minimisation strategies employed by your taxation advisors.

We look to see an EBIT to sales indicator at a minimum of 5% but preferably in the 10% to 20% range. When this indicator is below 5% the business is generating insufficient profit relative to its over-all activity and risk levels. If this indicator is above 20% then it is likely that insufficient reinvestment of profits is being made into the business to ensure it retains its market share and profitability in the future. When EBIT indicators are high then competitors are attracted into the market and competitive pressure will increase so reinvestment in the business for the future is important to ensure market share is not lost to them.

## **5. Marginal Cash Flow**

*Formula is: Contribution Margin minus change in working capital divided by sales expressed as a percentage.*

*This KPI relates the interaction with your client/customer with the working capital required to service them. It tells you if you are generating enough cash from your interactions with customers to sustain growth in sales based on the terms of trade you have with those customers*

Marginal cash flow is a very important indicator because it tells you whether or not your business is able to grow without the injection of additional funding.

Making profits does not guarantee you will have cash to spend in or draw out from your business. Nor does it guarantee your business can grow or even survive. While profits are important for long term viability, it is cash flow that is critical to day to day survival, and in particular operating cash flow.

The key investment that a business needs to fund day to day is in its working capital. This indicator tells you if you have a cash surplus or deficit after paying your operating expenses and funding your working capital requirements.

We look to see a marginal cash flow indicator that is at least greater than zero. And for ongoing sustainability it must also be large enough to ensure the free cash flow to profit indicator is also greater than zero.

## **6. Free Cash Flow to Profit**

*Formula is: Free Cash Flow divided by the Profit expressed as a percentage.*

*This is the KPI, which tells you the amount of profit you have left in cash after paying all expenses and making investments in both working capital and fixed capital.*

Your free cash flow to profit indicator tells you if your business is generating enough cash to survive in the medium to long term by reinvesting to maintain its productive capacity including all fixed capital requirements.

A business can survive in the short term by running down its productive capacity if it has insufficient cash flow, but long term viability requires ongoing investment to maintain future productive capacity.

We look to see a free cash flow to profit indicator that is at least greater than zero.

## CATEGORY 3 - STRUCTURE OF THE BUSINESS

These indicators measure how efficiently your business is structured and funded.

### 7. Debt to Equity

*Formula is: Net Debt divided by Equity expressed as a percentage.*

*This is the KPI, which tells you the overall funding structure of the business and how much has been invested by debt lenders and how much by equity lenders (owners). This indicator is an overall risk measure for the business.*

Businesses are funded by two types of lenders,

- 1) Those who lend it debt and
- 2) Those who lend it equity.

These two groups of people each lend to the business using different decision making criteria and they expect different types of returns on their investment.

#### Debt

When we look at the way a business is funded we treat cash as negative debt offsetting it against debt in the funding section of the post. We also include intercompany loans and ALL forms of financing (Hire Purchase etc)

This enables a clearer and more accurate view of how the business is funded between debt lenders and equity lenders.

#### Equity

The equity in this business is the NET of profits/losses retained after trading, plus investments made by owners less any net drawings by owners.

#### Debt to Equity Indicator

We look to see a debt to equity indicator of around 100% and not greater than 200%. If this indicator is less than 100% it indicates a conservative debt funding strategy and that there may be potential to inject additional funding from debt lenders to enable the business to maximize opportunities as they present. When the debt to equity indicator is greater than 200% it indicates an aggressive debt funding strategy is in place and that the business may be exposed to a higher risk of failure in the event of a downturn.

## 8. Working Capital to Sales

*Formula is: Working capital divided by Sales - expressed as a percentage.*

*The purpose of this KPI is to relate the overall sales 'FOR THE PERIOD' to the overall Working Capital at the BEGINNING and the END. This is again a type of measure to ensure that the Working Capital is consistent with the volume of activity in the business.*

The working capital to sales indicator tells you if you have an appropriate level of working capital for the level of sales activity your business is doing. The primary items of working capital in a business are accounts receivable, accounts payable and inventory, but it also include items like GST owed to you or by you and any remuneration related items waiting to be paid such as PAYG, Superannuation and leave provisions.

We look to see a working capital to sales ratio of around 20%. If this indicator is too high it may mean that debtors are not being collected fast enough and/or that the business is carrying too much inventory by not turning it over fast enough. If this indicator is too low it may mean the business is not paying its creditors on time or it has insufficient working capital to trade at optimum levels of performance and profitability.

## 9. Sales to Total Capital Employed

*Formula is: Sales divided by Total Capital Employed expressed as a percentage*

*The purpose of this KPI is to relate the overall volume of the business FOR THE PERIOD with the overall Total Capital Employed at the BEGINNING and the END. This KPI will help you determine whether a business is carrying excess capacity or has been overcapitalised.*

This is the indicator which gives the best view of idle capacity in a business. It tells you how much activity (sales) you are generating from your investment (Capital). It is important to get this balance right so the business does not get inefficient and "lazy" from being over resourced, or conversely inefficient and "stressed" because it is under resourced and operating under unacceptably high levels of pressure.

We look to see a sales to total capital employed indicator in the 200% to 600% range. This indicator varies more than some others relative to the nature of different business activities. Manufacturing types of businesses or business that need a lot of expensive machinery have much higher capital requirements than most service type business for example.

## **10. Operating Cash Flow to Total Capital Employed**

*Formula is: Operating Cash Flow divided by Total Capital Employed expressed as a percentage*

*This KPI relates the Operating Cash Flow to the overall investment in Total Capital Employed, to make sure that cash is indeed being returned by the business, rather than just good profits.*

This KPI is a cash flow health measure. It tells you if the operational aspect of your business is producing enough cash to sustain the ongoing investment in your fixed capital requirements without you having to borrow more from debt lenders or inject more equity funding into the business.

## **11. Free Cash Flow to Total Capital Employed**

*Formula is: Net Cash Flow divided by Total Capital Employed expressed as a percentage.*

*This KPI measures the overall cash performance with the overall investment for the whole business.*

At the end of the day this measure tells you if for all the effort of running the business and all of the investment in it, there is a positive cash surplus for the business owner to enable you to draw out cash to fund the life style you wish to pursue and to fund activities or causes that are important to you.

Ultimately a key objective of a business is to produce surplus cash for the use of its owners. This measure tells you if your business is achieving this objective.