BENCHMARKING
BEST PRACTICES

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EXECUTIVE **SUMMARY**

Maybe it's an inherent competitiveness or just the pursuit of improvement, but it's commonplace for people to seek out benchmarks they can use to assess their relative position or performance. It interests people to know how they compare to their peers. Benchmarks have a place in business, too, and can be an invaluable instrument to help business owners succeed. This whitepaper will cover some of the benefits that financial benchmarking can offer to business owners, helpful hints on how to approach the analysis, some pitfalls to avoid and finally resources that can help business owners get started.

BENEFITS OF **BENCHMARKING**

If a horse is running a race by itself, it will win every time. And we all like receiving the big trophy. Unfortunately, though, commerce is anything but a single-horse race, and even a personal-best doesn't necessarily secure the trophy or land a new client. In each market, there are many other horses or competitors, and globalization will only increase competition in future races.

Knowing how a company ranks relative to others—before the starting bell, halfway through the race and right before its conclusion—empowers management to evaluate the company's performance. Armed with that contextual information, they can potentially adapt strategy and affect the company's final ranking (if there is a "final ranking" at all in business).

Business owners and consultants see value in using peer group benchmarks both to understand the current situation and identify opportunities. "Industry comparisons are a valuable part of understanding and improving business performance as they can point out areas that business owners need to take a look at and see why they are performing below the rest of the industry," according to Chad Parker, partner at Sink, Gillmore & Gordon LLP, a Kansas-based accounting and consulting firm.

WHERE TO START: **DATA**

BEST PRACTICE:

When setting or applying benchmarks, be sure to ascertain whether the metric is an average for the industry or an above-average benchmark.

The most difficult step in financial benchmarking is acquiring benchmarks to use. Part of the difficulty stems from ambiguity around the word "benchmark", which could be interpreted as either an average statistic (a "C" on a school report card) or an above-average performance grade (an "A"). Depending on the data available, a business may benchmark using either standard, as long as the business owner understands what the benchmark is and how it compares to their ideal performance.

When selecting benchmark data to use, it's recommended to seek out data with the following characteristics.

1. Accuracy

While it may be obvious, in order for a benchmark analysis to provide meaningful insights to a business owner, the data used as benchmarks must be accurate, and the business owner has to trust its accuracy. This can be difficult given that every data set has its eccentricities: sources of the data, bounds used to determine outliers, sample size or even classifications.

When possible, a business owner can ascertain the data's accuracy through a little due diligence. Best practice requires that benchmarks

(1) come from a large enough peer group to be representative of the broader population and

(2) were collected using objective and error-free techniques.

Heed Ronald Reagan's advice to "Trust, but verify" the data prior to relying on it for decisions.

WHERE TO START: **DATA** (CONT.)

2. Timeliness

The race businesses run is real-time, and industries shift financially over the course of a year. Consequently, if a company uses benchmarks from a previous year, the resulting analysis could be ineffective or altogether misleading.

In some cases, old data can't be avoided. For example, 2012 tax return data won't be available for benchmarking until at least mid-2013. But whenever possible, ensure that benchmarks being used are the most recent benchmarks available to account for seasonality, economic cycles and other externalities.

3. Relevancy

Race conditions vary track to track. This explains why, before a large event, race participants will practice to acquaint themselves with the environment.

In a similar way, different industries, geographies and business sizes have their own trends and externalities to incorporate. One example might be a state government tax change that affects businesses operating in one state but not those in the adjacent areas. Or, the change could affect only businesses with annual revenues over $5M, altering their profitability.

In order to maximize data effectiveness, business owners should seek out data that is granularly defined and corresponds to the business being analyzed (e.g. operates under similar laws, uses the correct NAICS classification).

This characteristic of benchmark data—relevancy—ensures it is an "apples to apples" comparison.

WHERE TO START: **DATA** (CONT.)

Given these criteria, where can a business owner find applicable benchmarks?

Your accountant: It is rare that accountants today are just "bean counters." Instead, these financial professionals oftentimes have access to financial information sources and can share benchmarks with business clients as well as advice on how to change performance relative to those benchmarks.

Industry associations: For their members, these organizations will often collect and publish benchmarks specific to that industry (e.g. average sales per seat in a full-service restaurant).

Small Business Development Centers: Like accountants, these consultants have tools they use to guide young businesses and can provide insight into industry performance.

Other business owners: Like-minded business owners that aren't competing in the same geographic market could benefit from networking with each other and sharing information such as financial ratios or average costs. Be careful, however, to account for differences in costs of living, experience in the industry, market demand, etc. When possible, find and average data from several companies.

Sageworks Data: Sageworks clients use the data collected through our cooperative data model to understand trends in their industry and how they compare.

- *1,000 financial statements are entered per day for real-time reports.*
- *Data is available for more than 1,200 industries, as categorized by NAICS codes.*

PRIORITIZING **BENCHMARKS**

After securing an accurate, timely and relevant data source, the challenge becomes choosing which benchmarks to analyze and use as a proxy for business success.

Different industries, even different companies within an industry, could have different measures of success. For example, a contractor may have large subcontractor expenditures. Are these expenses normal considering the contractor's sales volume?

Rather than define all these industry-specific KPIs, this whitepaper highlights a few financial metrics that are almost universally important to businesses and—when analyzed together—provide a quick and high-level review of a company's health.

If a business owner has traditionally focused just on the company's cash balance in the bank, these metrics are an easy extension because they are intuitive and oftentimes accessible through a bookkeeping system or financial statements. The Additional Resources section found at the close of this paper includes a formula key for these and other benchmarks.

Also included with each subsequent metric are private-company industry data statistics from Sageworks' proprietary database. The averages provided here are for U.S.-based companies during 2012. These are real-time averages rather than "benchmarks," so companies should aim to outperform these averages rather than meet them.

PRIORITIZING BENCHMARKS: NET PROFIT MARGIN

Net Profit Margin =

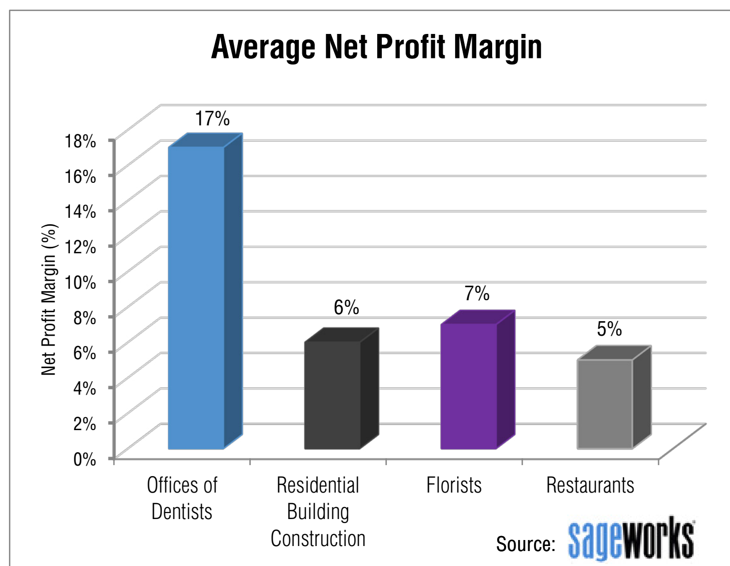
Net Profit Before Taxes divided by Sales

Net Profit Margin

Net Profit Margin is generally expressed as net profit before taxes in a given financial period divided by sales. Another helpful interpretation is how many cents of profit a business extracts from each dollar it earns in revenue. This is a rudimentary financial metric, but it is also the most important.

If it is available, check raw financial data or the formula used by the data source to validate that it is consistent with the company's calculations. This verification is especially important for this measure of profitability, as other firms might use after-tax profits or might make adjustments for owner's compensation. Private-company financials are sometimes adjusted to include compensation that exceeds market rates.

The graph illustrates how much variability there can be industry-to-industry with the Net Profit Margin. One glance at the graph, and readers might assume that dentistry is the industry to enter. But what restaurants might lack in profitability, they might make up for in volume. This is why relevancy is so important for meaningful benchmarks.



PRIORITIZING BENCHMARKS:
LIQUIDITY RATIOS

Current Ratio =

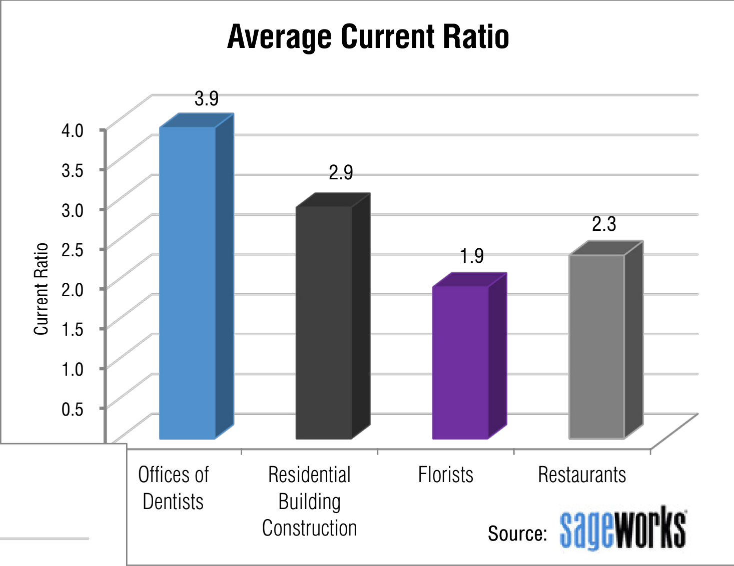
Total Current Assets divided by Total Current Liabilities

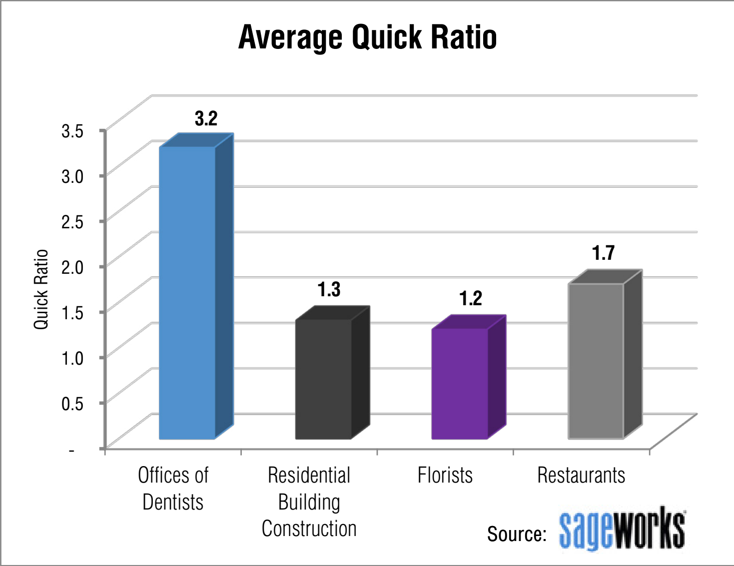
Quick Ratio =

(Cash + Accounts Receivable) divided by Total Current Liabilities

Liquidity Ratios

There are two fundamental liquidity ratios that should be analyzed jointly. Current Ratio is expressed as current assets divided by current liabilities. This metric shows the company's general liquidity, but it has some limitations. By including inventory in the calculation, it may provide a distorted understanding of the company's very short-term cash flow. The second liquidity ratio is the Quick Ratio, which is typically expressed as cash plus accounts receivables divided by current liabilities. Again, the Quick Ratio may not be perfect for gauging liquidity, but it is a useful and popular comparison to pair with the Current Ratio.





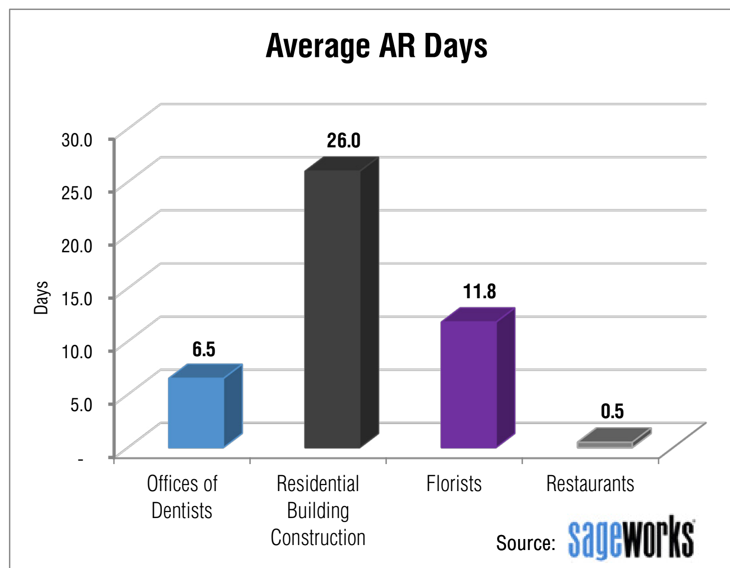
PRIORITIZING BENCHMARKS: **TURNOVER RATIOS**

AR Days =

(Accounts Receivable divided by Sales) multiplied by 365

Turnover Ratios

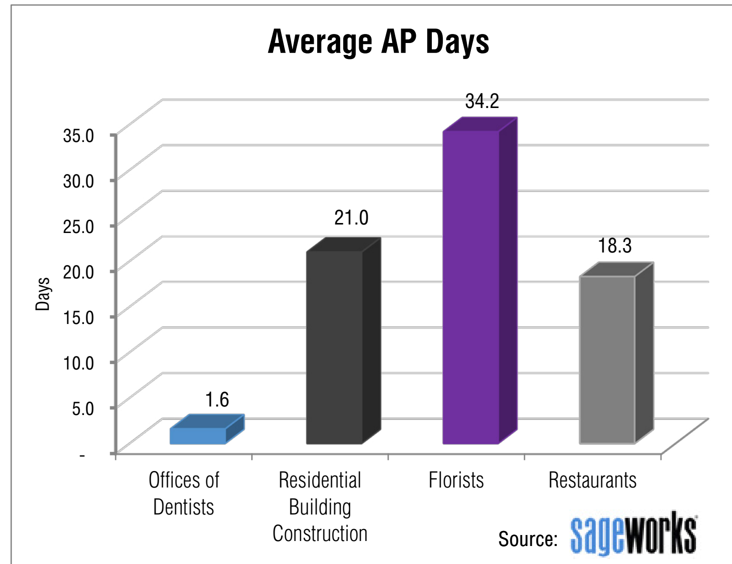
There are three fundamental turnover ratios to calculate. Accounts Receivable (AR) Days is expressed as accounts receivable divided by sales, multiplied by 365 days. It roughly measures the number of days a company takes to turn accounts receivable into cash. Lower numbers are more desirable since it is better to have cash in the bank than extra receivable accounts on the books.



AP Days =

(Accounts Payable divided by COGS) multiplied by 365

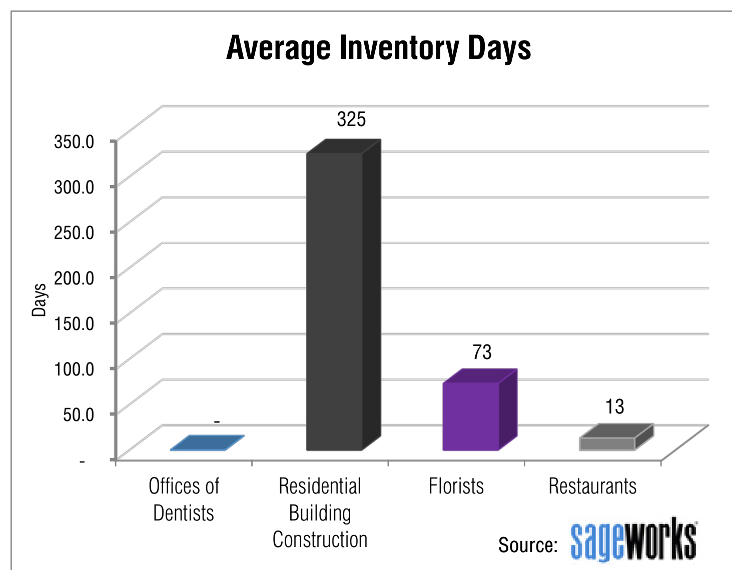
The second ratio, Accounts Payable (AP) Days, is expressed as accounts payable divided by cost of goods sold, multiplied by 365 days. The Accounts Payable Days ratio indicates the number of days a company takes to pay its vendors. Here, higher numbers are better because it means the company is able to hold onto cash longer.



Inventory Days =

(Inventory divided by COGS) multiplied by 365

The third turnover ratio, Inventory Days, is expressed as inventory divided by cost of goods sold, multiplied by 365 days. Inventory Days measures the number of days it takes to sell off inventory, but it is very specific to the industry. Imagine how long wine is stored at a winery compared to how long eggs are on grocery stores shelves. Generally, lower numbers are better.



PITFALLS OF **BENCHMARKING**

With these metrics in mind, there are a few missteps that a company should avoid when starting a benchmarking analysis. These include

Comparing Company A to Company B: Comparing one business to a peer group is helpful if the peer group is representative of the industry. However, if a company begins to compare itself to another, single company, there may be considerable differences that prevent a true comparison. For example, a new restaurant with new employees may not be as efficient as a restaurant that has operated in a similar market for thirty years; there are learning curves. Look critically at any benchmark analysis that restricts the sample size to only one other company.

Be careful with calculations and conclusions drawn from them: The benchmarks discussed in this paper—net profit margin, liquidity ratios and turnover ratios—are common in financial analysis, and their calculations are not generally refuted or changed. However, if a business expands their benchmark analysis to include industry-specific key performance indicators (KPIs) such as sales per seat, be sure to use the same calculation, period after period. If a subaccount is included for one period but then excluded for the next period, any trend analysis performed could be misleading.

Once definitions for the metrics are determined (A list of common financial ratios and their calculations can be found in this paper's Additional Resources), be sure that all members of management and the finance team have this set of definitions and—more importantly—be sure they understand what the metrics mean. There should only be one interpretation.

NOTE:

The Additional Resources section also includes a whitepaper that can help you prepare to present financial information in a meaningful way.

PITFALLS OF **BENCHMARKING** (CONT.)

Assume that numbers and performance are always changing: Positions in a horse race are constantly shifting: first to third, fourth to last, last to second, etc. Comparing a business to its peers only once per year may not be optimal, given that the industry is always changing even if your business isn't. The more frequent the benchmark analysis is performed, the sooner the business can identify trends and react.

OBJECTIVE:

The objective of a benchmark analysis isn't to build a benchmark report. The objective is to illuminate successes and challenges for the company and give business owners actionable insights.

Recognize that the benchmark analysis doesn't end with a variance report: Though it may seem that the work is complete once a company has compiled a report showing variances between its financial metrics and its peer group benchmarks, the work is actually just beginning. But so are the opportunities. Each variance gives the business owner a potential problem area to fix and the opportunity to improve the company's overall performance.

Likewise, the variance report will show in which areas the business is really excelling. Take pride in these successes, and see if the winning strategy can be implemented in other areas of the company.

ADDITIONAL **RESOURCES**

Managing and presenting financial information:

In this new whitepaper, "Fumbling Financials: Make Effective Financial Presentations," Sageworks consultants explain how business owners can synthesize and present financial information more effectively.
http://web.sageworks.com/reporting-financials-white-paper/

Estimate your income and expenses:

Accion has a downloadable spreadsheet to help you estimate your business and personal income and expenses.
https://secure2.accionusa.org/OLA/Applyonaccline/tabid/142/language/en-US/Default.aspx

Networking with other business owners for data sharing:

LinkedIn and other on- or off-line professional organizations provide the opportunity for you to connect with other business owners and ask questions specific to financial benchmarking.
http://www.linkedin.com/

Publicly available data:

The U.S. Census Bureau releases some data that could be helpful for benchmarking a private company, including growth rates and product lines by industry. A potential concern with using this data will be its timeliness.
http://www.census.gov/econ/industry/index.html

FORMULA **KEY**

Current Ratio = Total Current Assets / Total Current Liabilities

Quick Ratio = (Cash + Accounts Receivable) / Total Current Liabilities

Gross Profit Margin = Gross Profit / Sales

Net Profit Margin = Adjusted Net Profit before Taxes / Sales

Inventory Days = (Inventory / COGS) * 365

Accounts Receivable Days = (Accounts Receivable / Sales) * 365

Accounts Payable Days = (Accounts Payable / COGS) * 365

Interest Coverage Ratio = EBITDA / Interest Expense

Debt-to-Equity Ratio = Total Liabilities / Total Equity

Return on Equity = Net Income / Total Equity

Return on Assets = Net Income / Total Assets

Fixed Asset Turnover = Sales / Gross Fixed Assets

Sales per Employee = Sales / Total Employees (FTE)

Profit per Employee = Adjusted Net Profit before Taxes / Total Employees (FTE)

Profit Growth = (Current Period Adjusted Net Profit before Taxes - Prior Period Adjusted

Net Profit Before Taxes) / Prior Period Adjusted Net Profit before Taxes

Sales Growth = (Current Period Sales - Prior Period Sales) / Prior Period Sales

Debt Service Coverage Ratio = EBITDA / (Prior Period CPLTD + Interest Expense)

Glossary of these and other terms: [*https://www.sageworks.com/glossary.aspx*](https://www.sageworks.com/glossary.aspx)

ABOUT **SAGEWORKS**

Sageworks provides private-company financial information and develops financial analysis solutions. By doing so, we hope to give people data they can understand and use, which helps them make better financial decisions. We currently work with thousands of financial institutions, private companies and accounting firms across North America. For more information about Sageworks, our financial database or our solutions, visit https://www.sageworks.com.