



7 THE MAGNIFICENT

The 7 Key Performance Indicators
(KPIs) That Absolutely Drive Profit
And Cash Flow In Your Business

by **DAVID OFFICEN**



Running a successful business is so much easier when you know what to focus on.

The “Magnificent 7” KPIs I am going to share with you in this eBook are the critical things that focus your attention on profit improvement and generate bucket loads of cash flow in your business.

These 7 readily available numbers can be formulated on to a single page graphical dashboard that will provide all the insight you need to know about whether your business is performing as you expect. And if it's not, they will give you laser-like focus on the specific areas that need your attention to get back on track.

The Magnificent 7 KPIs that will drive profit and improve cash flow in your business are:

1. **Revenue Growth** – what's happening with the top line in your business? Is your revenue stagnant or growing? Do you have enough working capital available to cope with the growth?
2. **Gross Profit Margin** – how good are you at maintaining or growing your profit margin? Do you need a pricing review? Can you negotiate better deals with your suppliers?
3. **Overheads** – do you have effective controls over the variable overheads that often creep up over time? Is your accounting system set up to properly capture all of the relevant overheads?
4. **Accounts Receivable Turnover** – how well you are collecting your accounts receivable? Most (as in 95%+ businesses) are really poor at communicating expectations for payment and then following through on it. A good accounts receivable clerk will make a significant difference to your business cash flow.
5. **Accounts Payable Turnover** – how quickly are you paying your suppliers? Are there early payment incentives you should take advantage of?
6. **Days in inventory or WIP** – how much working capital have you got tied up in stock or finished product that hasn't been sold or invoiced to your customers?
7. **Utilisation** – a “lead” indicator to give you some insight into what will happen to your revenue in the coming days / weeks / months and allow you to take corrective action before it becomes a problem.

There are of course hundreds of other KPIs that can measure almost any facet of your business, however, the Magnificent 7 will give you 80% of what you need to truly understand what is happening in your business.

Revenue or Income Growth is the lifeblood of a business and it is a key component of good cash flow.

A business cannot sustain declining sales revenues for too long before cash flow starts to dry up and a myriad of other problems start to surface. Growing your income is one of the best ways to increase profitability. More importantly, evidence of strong revenue growth is a key consideration in the valuation of your business.



A word of warning though, too much revenue growth can be just as damaging to your business as declining revenue because it can require increases in working capital requirements. There have been many businesses that have failed because they grew too fast – it is called “over trading” and can be just as destructive and stressful as falling revenues.

The key to running a successful, stress free business, is to target the level of growth that your working capital reserves can sustain and then monitor it religiously to ensure you hit the target.

“Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pound ought and six, result misery.”

- Charles Dickens

Gross Profit Margin is the amount of profit you make after you’ve paid for the cost of goods, but BEFORE you pay for overheads and operating costs.

Small improvements in your gross profit margin will have a profound effect on your profitability, but so will gradually declining margins and this is one of the early indicators of looming financial trouble. Gross profit margin is usually expressed as a percentage of revenue and should normally sit in a very narrow percentage range.



If your gross profit margin fluctuates wildly from one period to the next it is very likely you have issues with your accounting procedures and they need to be sorted out quickly – this KPI must be able to be reliably measured.

A lot of people think their “mark-up” is the same as their gross profit margin – they are not. Mark-up is the amount profit you add to the cost price of an item to arrive at the selling price. Margin is the amount of profit you derived based on the sale price of the item.

This concept is best explained with a simple example. An item purchased for \$100 and sold for \$150 has a mark up of 50%. However, the gross profit margin is only 33%.

In a service business the largest component of the cost of sales is wages. The portion of wages that relates directly to providing the service should be recognised in your P&L as a cost of the sale. Just because your accountant may not show it this way does not mean that you shouldn't! Your gross profit margin is an important KPI and you need to be able to reliably measure it.

MARK UP		MARGIN	
COST PRICE	\$100.00	SELLING PRICE	\$150.00
MARK UP	\$50.00	COST PRICE	\$100.00
SELLING PRICE	\$150.00	GP IN \$	\$50.00
MARK UP %	50%	GP MARGIN	33%

“What you can measure you can manage.”

- Peter Drucker

Overhead control is something that most business owners believe they do fairly well.

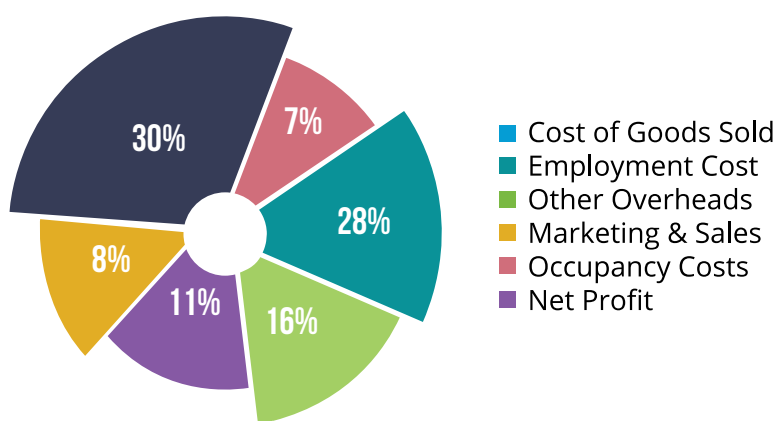
Fixed overheads, such as rent etc. can be difficult to change in the short term, hence the term “fixed”. However, variable overheads or those whose cost vary according to the business output, can and should be very closely monitored. For most SMEs, the largest variable cost is labour. Expressing this cost as a percentage of sales revenue and monitoring the trend over time can be a very strong indicator of the how well the business is managing this resource and will clearly forecast the need to recruit or shed staff. Many industries have benchmark data for key performance indicators and it is very worthwhile knowing how your business ranks against the benchmark data.

Looking at a single expense item may mask the full cost and for this reason I recommend the grouping of expenses into cost groups (e.g. Employment Costs – this grouping would include salaries & wages as well as all of costs associated with employment such as superannuation,

payroll tax, worker's compensation insurance, recruitment costs, provision of uniforms / pre-employment medicals etc.). Marketing & Sales would collate all of the advertising, on-going S.E.O. (Search Engine Optimisation) and S.E.M. (Search Engine Marketing) costs, attendance at trade shows, and any outsourced marketing activities.

If you have in-house marketing people, then a decision has to be made about which category they should fall under (i.e. Employment Costs or Sales & Marketing).

There is actually no right answer to this question, the decision should be based around ensuring you have access to meaningful information about your business. Anything is going to be better than the standard alphabetical listing of accounts that you probably get now.



“Overhead will eat you alive if not constantly viewed as a parasite to be exterminated. Nevermind the bleating of those you employ. Hold out until mutiny is imminent before employing even a single additional member of staff. More startups are wrecked by overstaffing than by any other cause, bar failure to monitor cash flow.”

- Felix Dennis.

Accounts Receivable Turnover is a standard measure for the efficiency of your debt collection processes.

The calculation measures the average number of days' sales you have tied up in your accounts receivable (and consequently not in your bank account!). The higher this number, the poorer your cash flow will be.

A word of warning on debtors, it has been my observation that aside from not taking an active interest in the financial performance of their business, apathy towards collecting debtors is the single worst thing that SME business owners do to harm their business. Running out of cash is the number one reason for business failure!

ACCOUNTS RECEIVABLE TURNOVER

This calculation shows how quickly credit sales are being converted into cash.

$$\text{Accounts Receivable Turnover} = \frac{\text{Net credit sales}}{\text{Average accounts receivable}}$$

e.g. = $\frac{\$1,800,000}{\$220,000} = *8.18 \text{ Times}$

To convert this into days : $\frac{365}{*8.18} = 44.6 \text{ Days "Average"}$

If credit terms are 30 days and the average time to collect is 44.6 days, there is considerable room for improvement.

Accounts Payable Turnover is the converse of Accounts Receivable turnover and measures the average number of days' purchases that are tied up in Accounts Payable.

ACCOUNTS PAYABLE TURNOVER

This calculation shows how quickly the company is paying its suppliers.

$$\text{Accounts Payable Turnover} = \frac{\text{Cost Of Goods Sold}}{\text{Average Accounts Payable}}$$

$$\text{e.g.} = \frac{\$440,000}{\$80,000} = *5.5 \text{ Times}$$

$$\text{To convert this into days} : \frac{365}{*5.5} = 66.4 \text{ Days "Average"}$$

If credit terms are 30 days and the average time to collect is 66.4 days, the business is using supplier credit to fund the working capital.

This is how much of your suppliers' money you are using in your business. The trend in this number is actually more important than the individual number and evidence of the accounts payable KPI getting larger is a very good leading indicator of cash flow strain.

A word of caution about accounts payable – it should only include amounts owed to suppliers. I have seen business owners include all sorts of weird items such as rent, loan repayments due, provision for sales commissions etc. included in their accounts payable. These amounts need to be shown correctly as Other Creditors.

"When it comes to money, ignorance is NOT bliss. What you don't know CAN hurt you."

- Sandra S. Simmons.

Inventory / Work in Progress turnover – similar to Accounts Receivable and Accounts Payable turnover, this KPI measures how frequently the company turns its inventory into sales.

INVENTORY TURNOVER RATIO

This calculation measures how frequently the company's inventory is turned into sales.

$$\text{Inventory Turnover} = \frac{\text{Cost Of Goods Sold}}{\text{Average Inventory}}$$

$$\text{e.g.} = \frac{\$440,000}{\$42,000} = *10.47 \text{ Times}$$

$$\text{To convert this into days} : \frac{365}{*10.47} = 34.8 \text{ Days "Average"}$$

On average, this business takes 34.8 days to sell its inventory.

If you are not doing proper, regular stock takes or properly recording production costs you cannot know what this measure is. This is often a good place to find lazy cash flow so monitor it closely. If there are slow moving or obsolete stock items, have a 'stock take sale' and move it on. It is a folly to avoid quitting obsolete stock or writing off work that is unbillable. Take the bull by the horns.

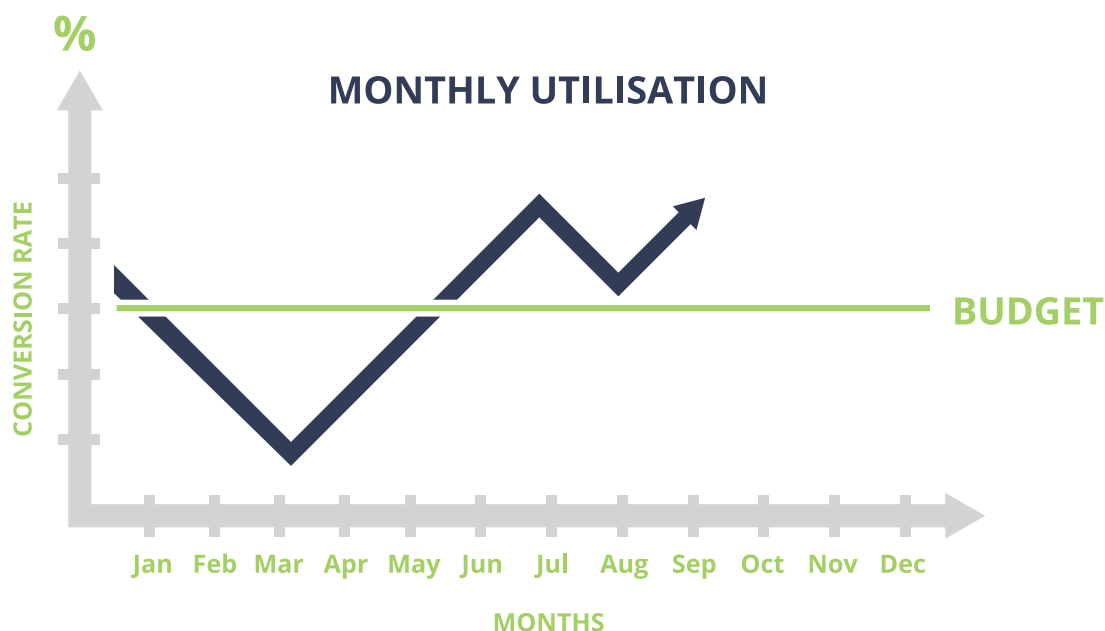
Utilisation is the only KPI in the Magnificent 7 that is forward looking or a “lead” indicator.

The previous six KPIs are all ‘lag’ indicators as they are derived from your accounting records and by their very nature are a record of history - they’ve already happened. However, by tracking appropriate utilisation measures you will have an excellent insight into what’s about to happen in your business.

I’m using the word “utilisation” as a generic term to describe the productive output of your business. It’s sometimes also referred to as “productivity”. For example, in a car hire business, utilisation is the number of days in a month that the vehicle fleet was on rent shown as a percentage of total available days for rent in that month.

For a business selling hourly labour such as trades, professional services, etc. the measure would be number of hours sold as a percentage of hours available. For a business doing lots of quotes or tenders the percentage of successful quotes is a key number to measure and monitor. An accommodation provider will measure room occupancy rates.

The higher the utilisation rate of your resources, the less waste or idle time and the more profit you will make. The greater the sensitivity of the business’ profit to this number, the shorter the measurement period should be.



“Productivity is never an accident. It is always the result of a commitment to excellence, intelligent planning, and focused effort”

- Paul J. Meyer.



About The Author

David Officen is a business improvement expert who is passionate about helping SME business owners build their businesses through a better understanding of the key numbers. He has been running businesses, including several start-ups, and assisting other business owners since the early 1990's. His professional business career includes a 15 year period as a partner in a very successful Western Australian accounting firm. David has formal qualifications in accounting and information systems, he is a CPA and also has an MBA.

For a complimentary report of your Magnificent 7 and how to use them to improve profitability and cash flow in your business, send us an email to **enquires@procfo.com.au**. We'll also include a quick 5 question assessment that will give an insight into the quality of your accounting records and bookkeeping so you know how ready they are to support your quest to manage your business using the Magnificent 7.



Tel: 1800 proCFO (776 236)

Email: enquiries@procfo.com.au

Address: 3/113 Royal St EAST PERTH WA
6004