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Benchmarking and Budgeting for Success

For many companies, reviewing and managing their financial results is simply an exercise of looking at the P&L and balance sheet after the close of a month. Management then makes a brief determination as to the results usually based on how current month compares with the prior month close, or the same period of the prior year. In essence, the company is informally benchmarking and budgeting against its own actual results. This style of financial management does not take into consideration how the company's results compare with its industry or competitors, or even with the goals of management and shareholders. Establishing and utilizing benchmarks and budgets to gauge and improve financial results should be a part of every company's best practices.

Benchmarking can be as simple as selecting a few key operating ratios by which the company wants to measure its results and management of assets. For example, a company sets P&L % of sales benchmarks for gross margin, SGA, and pre-tax profit. Actual results are then compared to these benchmarks with deviations explained. This type of "high-level" benchmarking focuses management on achieving targets, and also highlights areas of potential operating weakness.

Benchmarks should be established for the balance sheet as well. For example, days sales outstanding (DSO), days payable outstanding (DPO) and days in inventory (DII), as well as days in working capital (DWC) and the current ratio are good measures to benchmark. Internal benchmarks can be established based on industry ratios as published in sources such as ***RMA Annual Statements Studies***, or based on published results of some of the top performing public companies in your industry.

Benchmarks should be established based on achievable goals that make sense in your business and your industry. Unattainable benchmarks will be dismissed as useless. Benchmarks that are easily achievable lack purpose. I always try to set benchmarks to be on the aggressive side so that they function as a way to align the company's management to focus on efficiency of the entire operation in generating revenue, servicing customers and managing working capital. The result is costs or processes that are not generating good returns are easily targeted. Also, with benchmarking, a company may find it is necessary to convert more of its fixed cost structure (including wages and salaries) into a more variable cost structure to reduce risks and allow for achievement of financial goals.

After benchmarks have been agreed to, then budgets should be established that present a more detailed road map as to how operating goals will be achieved. Budgets should always be compared to actual operations and deviations explained. Budgets and benchmarks will also act as an internal audit function to highlight accounting problems, such as timing issues for revenues and costs, or problems with collecting AR.

The annual budget should present both forecasted operating results and also expected cash flows. This tool provides management with a telescope to see upcoming periods of deficient and surplus cash far enough in the distance to allow for planning to avoid working capital surprises. The cash flow budget should also be

a component of the overall capital budget process, which determines funds available to invest in growth, pay debt and make distributions to shareholders.

If you need assistance establishing or reviewing your benchmarking and budgeting processes, please contact Harvest CFO Consulting by telephone 724-934-4752, or e-mail dhillier@harvestcfo.com. Also, please visit our website at www.harvestcfo.com.

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