Financial Health Check

BARONSMEAD
EXPERIENCE & INNOVATION

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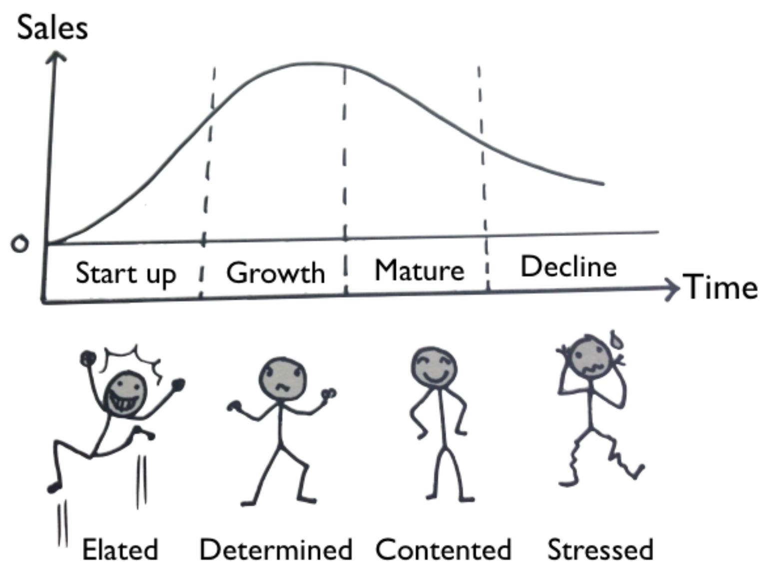
Words by Ian Gray
Illustrations by Quin SQ Thong

Introduction

On the understanding that turkeys rarely vote for Christmas, stakeholders in companies might find it wise to take a long close look at the explanations of company performance, good or bad, offered by the executive board.



Every product or service has a finite life cycle. So even when the business seems to be riding on the crest of a wave, can you be confident that the necessary investment in consumer trends, product refinement and new development is taking place to preserve market leadership – even if that means reduced dividend or executive bonuses? And if the company is performing below expectation, exactly what or who is the problem?

To gain an understanding of the dynamics within the organisation, there are certain factors common to most businesses that indicate its state of health. This brief guide cannot offer a definitive analysis of a particular situation but it can highlight those key areas of consideration and provoke the questions that stakeholders need to be asking.

Financial Health Check

Key points to help stakeholders understand what is really going on inside the business.

Answering these 10 basic questions could help you determine whether it's time to seek some advice …

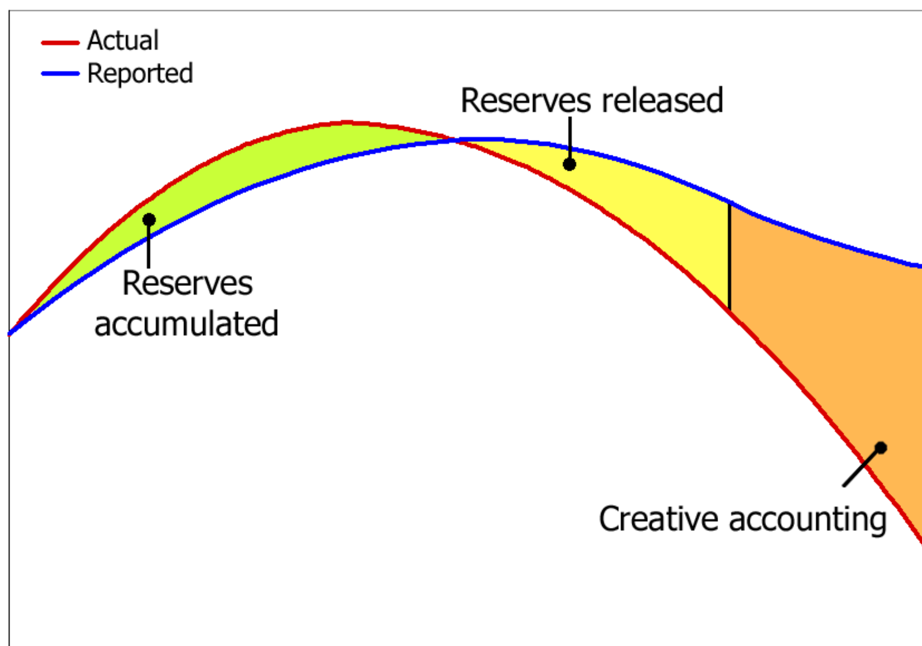
- Are you always short of money?
- Can you pay your suppliers on time?
- Are your sales going up or down?
- Are you profitable? If so, is your profit growing in proportion to your sales?
- Is your order book growing or shrinking?
- How recently did you review your overheads? (Or for budgeting, did you just take last year's figures and add 10%?)
- Do you often find there's too little of the right stock and too much of the wrong stock in the business?
- What would happen if your major customers asked for a reduction in price?
- How well do you know what's happening in the marketplace, and how your competitors are doing?
- Do you find you're not winning business?

Sometimes it is not easy for those closest to the business to recognise or possibly admit that all is not well. The entrepreneurial enthusiasm and optimism of many business leaders may encourage them to believe that problems are only temporary and will be overcome. This may be true, but experience reveals that recovery most often requires additional resources with a very special set of skills and experience that are rarely available in house.

For a more thorough review of the state of your business, why not take a look at the Financial Health Check?

Creating a False Impression

Reality Gap



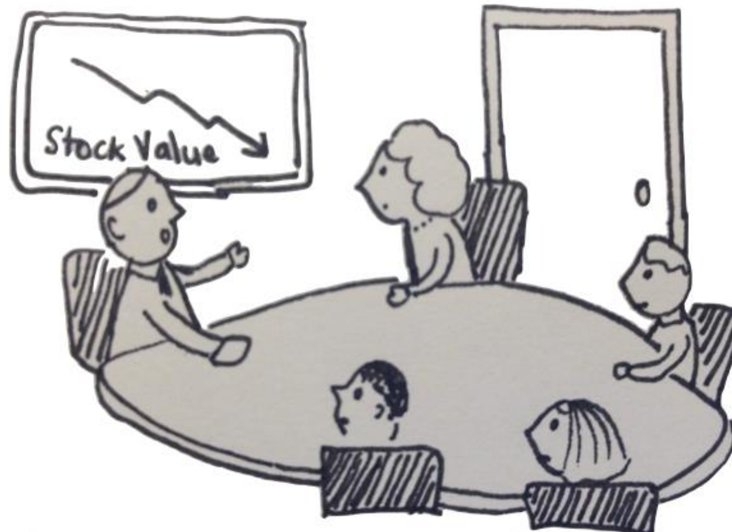
As they develop, businesses tend to be prudent and 'tuck money away'. In the early stages of underperformance these reserves are released, often with the view that it will be okay once we get past the end of this quarter, or once we've signed this contract we've been chasing for a while. The business then slips into the area best described as creative accounting. That's the reason for such massive write offs when the problem is finally addressed.

Sometimes revenues are flattered. Look at the company's accounting policies: are sales booked when an order is placed or when it is completed? Have the sales been generated by a related party? In the UK there was a famous case where the company in question bought its customers when they could not pay their bills. No cash was received but the external receivable disappeared after the acquisition. Parmalat, the Italian dairy firm, is another example of non-existent sales.

Look for ratios that are difficult to manipulate. Revenue per employee may appear high compared to the peer group. Sales figures can be fabricated but employee numbers are harder to manipulate.

Company accounts provide a snapshot of the business position at a given moment. Therefore with a little creative thinking it is possible to present the most positive working capital position in a particular accounting period. Typically, a business may apply pressure on its customers to secure rapid

payment prior to producing accounts; credit sales from a current month to the month before; delay payment to suppliers to a later period; or open new lines of credit with new suppliers



I was to propose we sweep it under the carpet, but our office floors are tiled.

On paper, these measures can help to camouflage a problem in that set of accounts but only in the short-term. Looking closely at the stock and accounts payable and receivable should give a more accurate picture of the position.

Working capital is a vitally important discipline, and the smart CEO will give it the attention it deserves. All too often, businesses approach liquidity issues by attempting to raise new equity or by introducing swingeing cuts when a stricter application of the controls over stock levels, accounts payable and receivable would be far more effective at improving the cash position.

How to Spot Failure

In 1968 Edward Altman, a professor of finance at New York University, published the Z-score formula for predicting corporate failure. The score is based on five financial ratios that he labelled X1 to X5. The Z-score is calculated by taking each ratio, applying weightings to each of them, and then adding the results together. The Z-score formula is calculated as follows:

$$Z = 1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 0.99X_5.$$

The individual ratios and what they measure are:

X_1: Working Capital / Total Assets. Working capital is the difference between current assets and current liabilities. This ratio measures liquid assets in relation to the size of the company.

X_2: Retained Profits / Total Assets. Retained profits are a company's cumulative profits that have not been paid out to shareholders. Small retained profits are found in weak or young companies. This ratio measures profitability that reflects the company's age and earning power.

X_3: Earnings Before Interest and Taxes / Total Assets. This shows how productive a company is. This ratio measures operating efficiency. It recognises operating earnings as being important to long-term viability, which is reflected in the high weighting given to this ration by Altman.

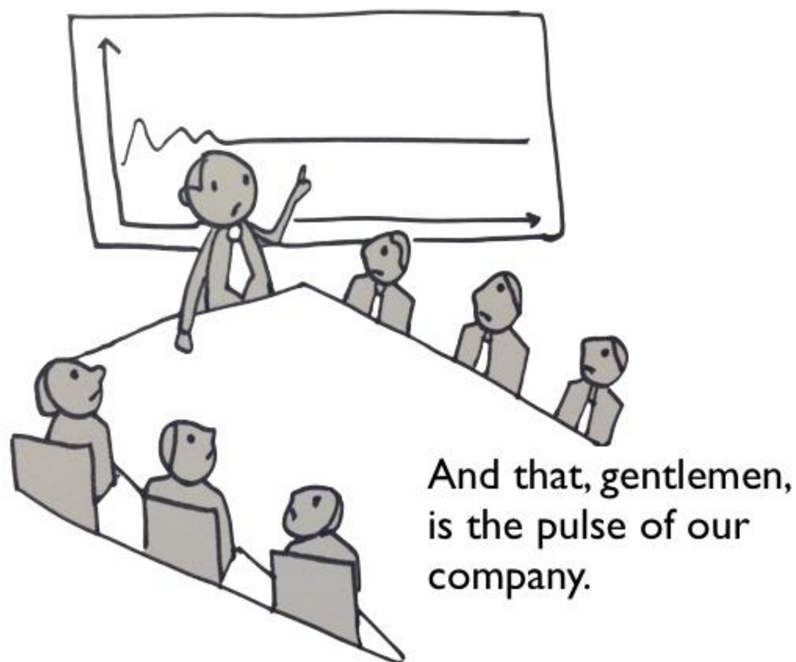
X_4: Market Value of Equity / Total Liabilities. In the case of a private company Shareholders Funds would replace Market Value. This shows how far a company's assets can decline before its assets are below its liabilities and the company becomes balance sheet insolvent.

X_5: Sales/ Total Assets. This ratio measures the ability of the firm's assets to generate sales.

Strong firms will have a Z-score of three or greater. A company with a score of less than 1.8 is seen as having problems and heading for trouble. All the

numbers can be found in a company's financial statements and market values can be found in the financial press.

While the result of adding the weighted ratios is a good indicator of failure within the next two years, the results need to be interpreted by an expert. For example, when looking at ratio X1 it can be a bad sign if a company has negative working capital. On the other hand it can be a good thing; a growing company will be cash generative.



Another useful metric, used by banks, is debt as a multiple of EBITDA. It is important to look at other indicators and these are discussed below.

Awareness

This chart demonstrates the degree of awareness that each of the stakeholders in a troubled business is considered to have.

Employees are the front line through which the business communicates with its customers and suppliers. They are the eyes and ears of an organisation.

Executive Directors like employees, see the immediacy of the situation.

Trade insurers: Trade insurers see the payment pattern for any one company from the reporting of its insured customers. They have a better overall view than an individual supplier.

Suppliers & Customers will see only see their individual relationship with the company.

Banks: depending on the relationship between the business and the bank and the ease with which information flows, it may be difficult for the bank to get an early insight into difficult trading conditions.

Asset based lenders: despite their reporting requirements and routine audits, the content of these are focussed on validating the quality of security the lender has and not on the future outlook.

Non-executive directors: the interaction of the Non-executive director with the company and the degree to which the Non-executive is involved in the company is a subject under much scrutiny at the moment.

Shareholders: often the last to discover the troubled status of the company.

Signs of Stress

Stressed??? What do you mean stressed?

Below are some of the key indicators of stress in a business.

Working Capital – taking care of the basics

Among the most reliable measures of a company's health and well-being is working capital – the readily available assets that the business can use for its day to day operations. Working capital provides the ability to fund production and pay suppliers. It is often defined as the amount of current assets that exceed current liabilities. The better the working capital management, the lower the liquidity risks and the more resources the business has to finance growth.

There are several performance measures that can be used to assess the working capital position. However, there are also short-term means of disguising a problem in the company accounts. So the concerned stakeholder needs to be aware of the danger signs. When reviewing working capital,

business analysts will focus on three major areas: stock levels, accounts payable and accounts receivable.

Accounts Payable

The well-managed business will have obtained the most favourable terms achievable (without endangering the health and sustainability of its suppliers, and will be paying its bills according to the terms agreed. If the period taken to pay suppliers begins to lengthen, this may well indicate a shortfall in working capital – especially if it is accompanied by an increase in borrowing not specifically allocated to an investment/expansion programme. Another indicator of problems will be an increase in disputes with suppliers and a rise in legal proceedings against the company. Borrowing is not necessarily an adverse indicator, as many businesses, particularly in manufacturing, have to borrow to finance production and may have to wait a considerable time to receive payment. However if the borrowing coincides with other symptoms, especially a persistent failure to produce management accounts on schedule, there may be a significant problem with working capital.

Accounts Receivable

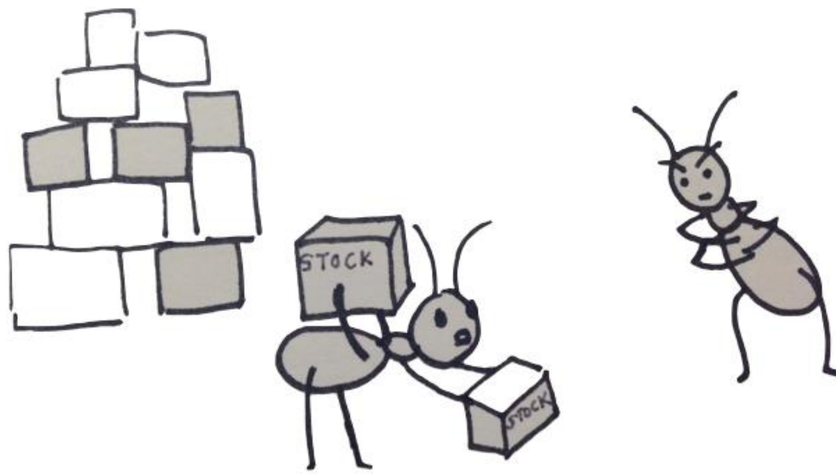
Like accounts payable, a useful indicator of the working capital positioning is the average number of days it takes to receive payment from customers. The symptoms already outlined, an increase in this payment period and, or, rising disputes with customers over delivery and service will also indicate a deteriorating working capital position.

Stock Turnover

The more capital tied up in stock sitting on shelves the more likely it is that the business will need to fund working capital through borrowing. Where working capital is well managed, the business will have a stock turnover ratio comparable to its closest competitors and that ratio will be broadly consistent with historical performance. Improvement in stock management such as just in time supply chain solutions will tend to indicate that good financial controls are in place. Paying close attention to exactly what is in stock for how long is also important. Key lines may be selling well and the turnover ratio impressive but how much money is tied up in slower moving or redundant stock that might still be in production? Markets, tastes, styles and technologies move ever faster. The business must keep pace with these changes.

Stock - what exactly is happening in the warehouse?

Having already highlighted the impact of stock control on working capital, it may be useful to arm the stakeholder with more information on how efficiency in this vital discipline can be assessed. No business can operate without some form of stock– whether that is raw materials, finished product or simply pens and paper in the stationery cupboard. What matters to the business however is how much money is tied up in stock and for how long. And in the case of a manufacturing or retail company, how much slow moving or even redundant product could be showing in the accounts as a business asset.



The consultants say stock movement is good. So, I'm moving stock from one warehouse to the other.

Stock must be available when and where it is needed. Production will grind to an expensive halt if a factory is left waiting for raw materials. Supply chain management is about ensuring security of supply with the lowest practical amount of working capital committed. Achieving this goal has been the driver for "Just In Time" production, where raw materials arrive at the time they are actually required. However, "Just In Time" is neither the only consideration nor the only stock control model available. Some businesses will operate on a set re-order level system based on the time it takes to obtain new supplies. Some will re-order only on the basis of economic quantities – the amount that enables them to secure the best price for supplies. The important thing is that there needs to be a recognisable system and that the results are measured.

Measuring the effectiveness of whichever methods are applied is often a matter of comparison with competitors and similar business models. Businesses can obtain real competitive advantage from looking beyond their traditional rivals to spot new ideas being used elsewhere that could be transferred effectively to their specific requirements. Open data exchange between

retailers and suppliers is creating a revolution in supply chain management. For example, systems now exist that enable a shop floor assistant to take a customer's order for out-of-stock/catalogue items after checking availability on the supplier's database and calling off the item electronically. EPOS (Electronic Point Of Sale) systems are linked directly to suppliers in order to re-order automatically. Even blank spaces on the store shelf can now be detected electronically to trigger re-supply. So the big question is how does your company compare on the stock management front? Can it demonstrate improvements? Is it taking advantage of these new technologies? Is it even aware of them? A common measure of efficiency often applied is the STOCK TURNOVER RATIO, which is calculated as:

$$\frac{\text{Cost of Goods Sold}}{\text{Stocks}}$$

This measure shows how often a business sells the value of its stock during the year. Roughly speaking, the more often the better, as this indicates that the business is accessing the profit from sales more quickly and minimising the amount of money tied up in stock. Another version of this measure is that shows the number of days sales held in stock:

$$\frac{\text{Stocks x 365}}{\text{Cost of Goods Sold}}$$

This shows on average the number of days that money is tied up in stock. Again, the less time the better but it is important to view this in comparison to similar operations. A business that has its eye on the ball will know how well it is performing by this measure. Equally important when reviewing a company's accounts and trying to understand the true value of its assets is to know what type of stock it is actually holding. For example, the XYZ computer company is selling its latest high speed laptop model made in its China factory by the bucketful. Stock in this section is turning over so fast that it can hardly keep up with supply. However its Korean-made desktop model, once the company's major cash cow, is hardly moving at all. Yet in order to keep the plant open, the desktop is still being made in quantity only to sit in a warehouse somewhere – a plus on the balance sheet but a drain on the business.

Staff

People problems are a visible sign of a distressed company; high turnover is generally related to employee dissatisfaction and a confused organisational structure. Specific reasons might include low pay, poor working conditions, long hours or a negative atmosphere. In a troubled company staff turnover is generally high and the most able people will have left. It is however important to analyse staff turnover by length of service. There are some industries where turnover of junior staff is high but low for long serving employees

Business Structure

From its very earliest beginnings through to multi-national corporate status, the efficiency, performance and profitability of a business will be heavily influenced by its structure. As a stakeholder you want to know whether your prevailing structure is propelling the business forward or holding it back. In the small entrepreneurial run business, the lines of communication are short. Decisions, however centrally made, reach the key workers quickly and the performance tends towards the dynamic. But as the enterprise grows, the entrepreneur has either to delegate some of the decision-making process, or to settle for a slower pace of operation. In a major enterprise, effective communication becomes even more challenging, despite the vast array of Information Systems that are available to the modern business.

Multi-national organisations frequently have separate sites around the world dealing with different functions, such as: research and development; manufacturing; sales and marketing Europe; sales and marketing US. It is not entirely unheard of for one of a multi-national's sales team to be tendering against another of its sales teams for the same project, conveniently driving down the price for the customer while obliterating the profit margin for the parent company. Similarly, product developed in one continent fails to be compatible with products produced by the same company elsewhere, or branding fails to respond to local market sensitivities. Sales teams fulfil their sales targets only to find Production cannot keep up with the orders, or that there are not enough service engineers to keep customers happy.

So how do organisations manage to get themselves into these kinds of problems? Answer – poor communications between inflexible management structures, or "silo management" as it is sometimes called. Here's how it works or doesn't! Sales people report to a National Sales Manager reporting to the Sales Director of the Sales division who sets the targets for sales. Production being a separate Division in a separate location only talks to Sales at board level. So it is only after a problem has been passed entirely up the line that a different division gets to hear about it. Business-critical orders find themselves on the back burner because nobody told the Service team that they were top priority.

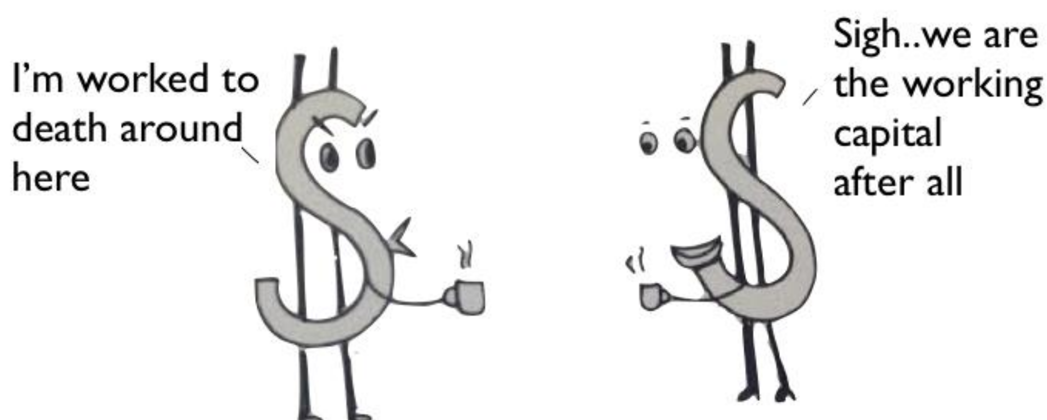
There are many different structural models to choose from, each with its own advantages and disadvantages. The key factor remains effective communications at all levels. The most revealing sign of all not being well in this area is a culture of finger pointing: blaming another department or international division for poor performance, lost business and results. Failure to

recognise or understand the bigger picture and to appreciate the role of other business disciplines can have a powerfully demoralising effect on a business. This will be reflected in high turnover of management and staff. The key reporting phrase will be "If only the people in (insert any division) did their job properly……" The bigger the business, the deeper the silos can be. The cures available are also numerous but will largely depend on making as many people in the business as possible "customer facing" – encouraging and empowering teams to be responsible not just for one small aspect of performance but for the complete delivery of quality service.

If you suspect a problem resulting from corporate structure, ask management about its reporting systems. Examine the organisational chart and if you don't understand it, odds are that the people in the business won't either. Bureaucracy adds cost and complexity. It also helps the less visionary of managers to build a wall about them. An interesting measure of structural efficiency is how much time the senior management team spends in formal/regular meetings. The answer is usually far, far too much. But hey, it's a great way to avoid getting on with the job!

Banking and Borrowing

Almost every business will borrow money at some stage – and banks will be eager to lend provided they are convinced of the business being able to service its debts. Stakeholders and shareholders want to know that the company's borrowing is within reasonable limits and that it retains the confidence of its bankers. Fortunately there are usually strong warning signals if all is not well, some of which we have covered under working capital. Key amongst these is that the business is always operating at the very limits of its facilities. Suppliers are not being paid on time and the business may be on "stop" with some of these. There may also be repeated requests for further bank funding, with this being explained away as a temporary setback, seasonal lull or short-term problem. Although sometimes slow to react, banks monitor for such symptoms.



As many small businesses know, it can be remarkably difficult to persuade a bank to continue its support and to make further credit available. However, the bank will assess its position and advance new money to allow the business to sell assets or effect a recovery plan and reduce the bank's exposure. If the bank does not feel justified in continuing to service a business, it may simply ask for the company to take its banking elsewhere. One measure used by banks to assess a company's ability to service debt is the ratio of interest payments to profits. The more keen banks are to lend, the lower that ratio can become and the higher the risk the bank is prepared to take. The stakeholder should

remember that banks lend against their own criteria, which may be different to those of a potential private investor.

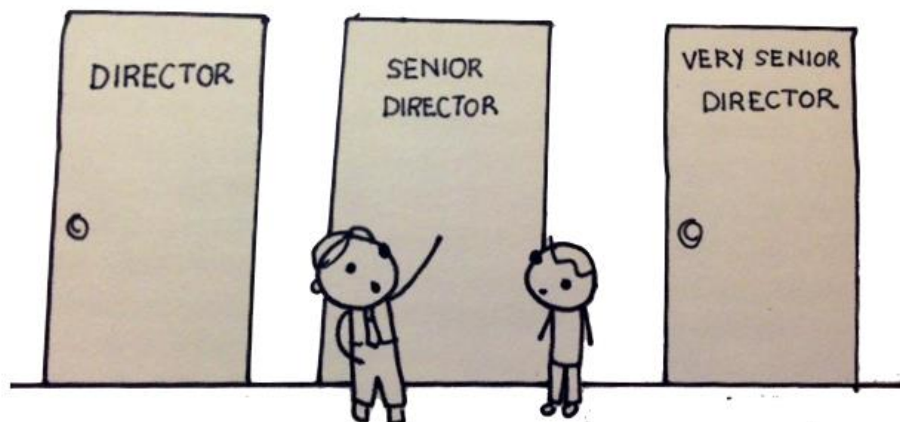
There are no absolute levels for sensible borrowing but if interest payments do not exceed one third of Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA), then the interest cover of three times can reveal considerably higher ratios as not uncommon and these should be said to be at a satisfactory level. A cursory glance through business reporting will be compared to the industry/sector average.

It is clear however that risk increases with lower interest cover. Banks set measures for monitoring the performance of a business, which are known as covenants. These can include EBITDA and the Tangible Net Worth of the business, reviewed on a regular basis. If and when a bank believes that the company could be in danger of reaching a point where it will not be able to service its debts, it may insist on an Independent Business Review – usually conducted by one of the major accounting practices. It is worth noting that the IBR will be undertaken at the expense of the business concerned, often adding to its immediate cash problems.

A crisis in the cash position of a business rarely arises overnight. Directors have a responsibility to take appropriate action, and too often that action is delayed. If the warning signs are there, then stakeholders should be expecting to see their Board seek assistance at an early stage. Sometimes this involves seeking outside expertise through the appointment of additional Non-Executive Directors or other advisers who have the appropriate skills and experience to help the company through its difficulties. Regardless of who calls for such appointments, the first duty of any Non-Executive Director or other adviser is to the company. They are there to advise and act in the best possible interests of the company. As such, they can offer a useful safeguard for the interests of stakeholders.

Who is in charge?

Some people genuinely possess real leadership qualities and vision. They are the exception. Boardrooms are populated by the gifted to the downright uninterested and it is important for stakeholders to understand the difference. All too often, appointments are made that offer the potential to reward failure through the culture of golden parachutes when what is needed is a passion for success. So how can you weigh up the capability of your CEO?



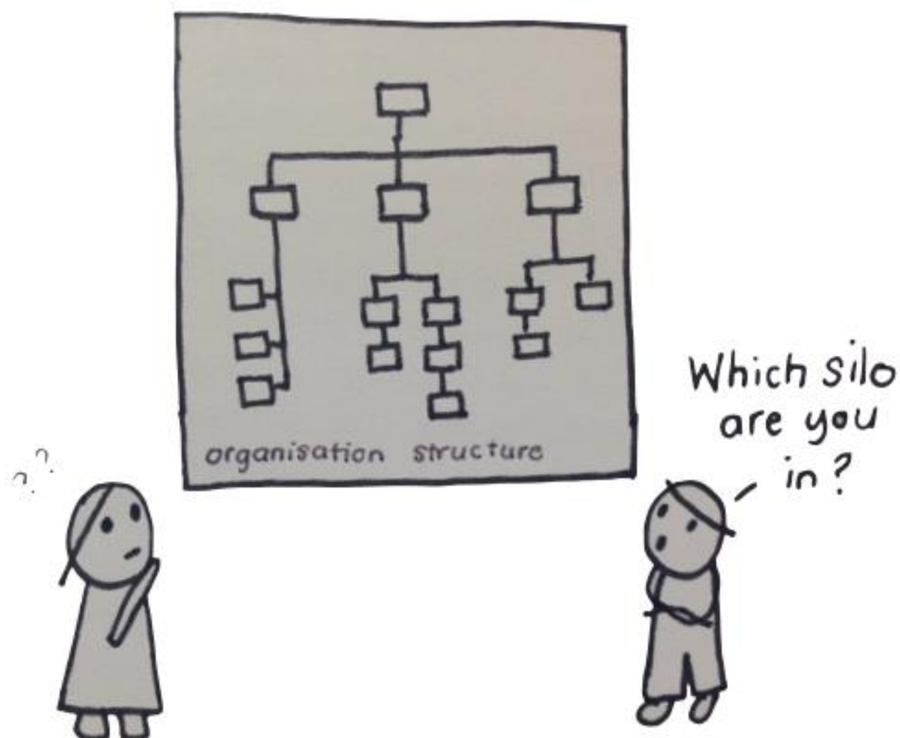
Everyone needs time to produce results. A shake up may be needed when a new appointment is made and it takes time for a new direction to permeate through all the layers of the organisation. However if after that bedding-in period staff turnover is high, particularly at the management level, and morale is low, a close look at the person in charge might be in order. Bear in mind that all organisations resent change, and that's what a change at the top usually brings. New ways of working will always create tensions and some people will leave, but there should come a point fairly quickly when those that remain gain inspiration and confidence from the new person in charge. Track record is an obvious indicator of capability. A Chief Executive should usually have left a business in a stronger position than when they inherited it, Acts of God, government, and oil prices permitting. However, it is worth noting in what circumstances success has been achieved. The stakeholder needs to be

aware that the skills required to drive a successful enterprise forward are not necessarily the same as those needed to turn a company around.

The weight of success or failure should not rest entirely on the shoulders of the CEO. Every one of the management team has to deliver. How that management team performs is reflected in many ways. For example, how is the business perceived by the public, the press or government? Are the announcements of future plans accepted enthusiastically or treated with scepticism? Is City confidence in the organization high and are shareholders positive about their investment? Are the accounts produced on schedule and how close to budget is the business performing? If problems exist, what steps are being taken to improve the position? Faced with a downturn in fortune, a strong management team will recognize the need for action, and that may include the need to supplement the existing skill set through the appointment of external advisers or non-executive directors.

Communication

Customer relations, industrial relations, media relations, public relations, supplier relations – a business depends on the quality of its relationships. And as every good agony aunt will tell you, the secret of good relationships is communication. Neglect or mishandle that communication and the business will suffer. The effective company will have a clear business vision and strategy that it communicates enthusiastically to all relevant parties: customers, suppliers, shareholders, bankers, financial and business journalists, and even government in some cases. Last but by no means least, that strategy and vision will be understood and supported by the managers and workforce.



Internally, Staff at all levels need to be informed about company progress, outlook and opportunity. Failure to do so will simply ensure that the information vacuum is filled by rumour and ill-informed gossip which will inevitably filter beyond the company. The attitude and involvement (or lack of it) of front line staff is a good indicator of the internal communication process – as is a mismatch between what the company's publicity says about its service and the reality as experienced by customers. You may wish to ask what mechanisms are in place to ensure that vision, strategy and information are

adequately disseminated. You may particularly want to ask such questions when employer/employee dispute negotiations appear to be taking place in the glare of publicity.

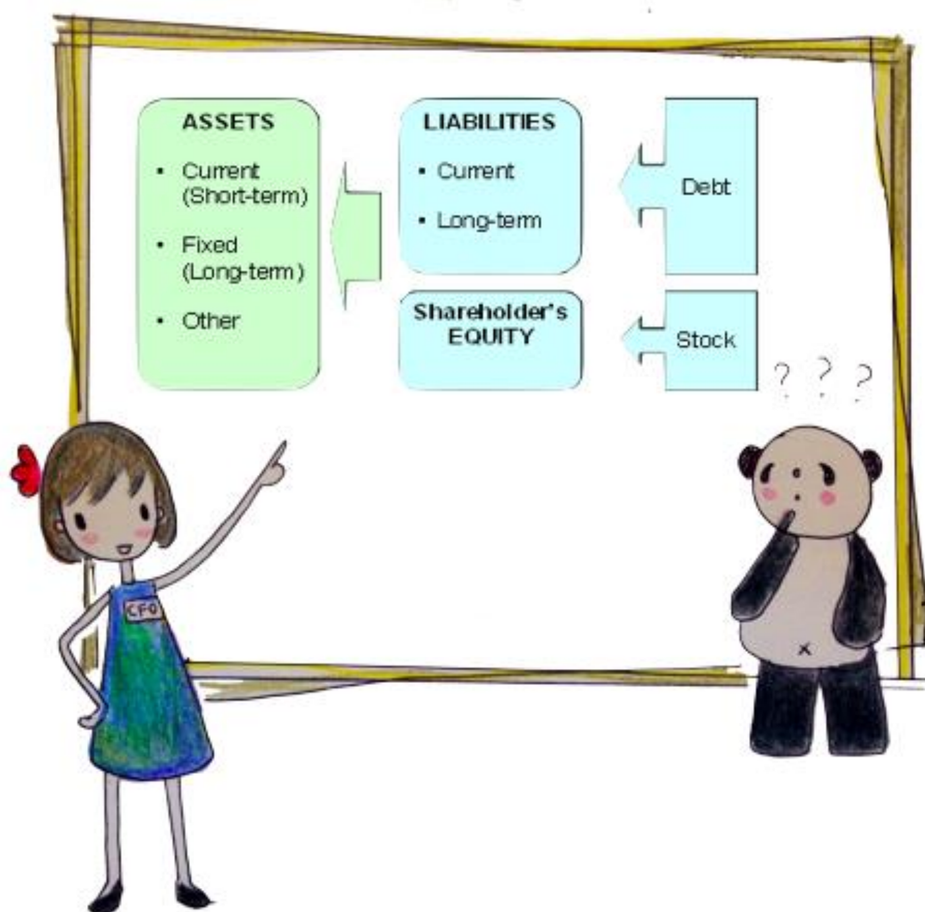
Externally it is important to know that the business is spending the marketing budget wisely. Creativity can be good but often expensive. Ground-breaking, award winning advertising campaigns aren't always customer winning. A change of direction and positioning might open up new opportunities but could also lose core business and loyal customers. Watch out for diminishing returns on a rising advertising budget.

Communications need to reach out beyond customers to all stakeholders. Effective PR isn't about media manipulation and spin doctors, it is about ensuring that the business is understood and trusted by the people who matter, something that cannot be accomplished through ducking the question, half-truths and a slick spokesperson. Look to see how much exposure the business receives in relevant media and assess how positive that coverage is. And if something goes wrong, consider how well the problem is dealt with. Or does the company seem to stagger from one PR disaster to another?

The more that a business engages with its stakeholders, the better it will be understood. As a shareholder, you are a key audience for the company. So how well does it communicate with you and how well do you understand what the business is doing? If you feel that you are ill informed and neglected, then it's quite likely that every other key relationship is suffering in the same way.

Finding the Right Advisers

When business is going well, the management team may have all the necessary skills to maintain and build on that performance. When business performance is in decline or the company is in serious distress, an entirely different skill set and experience may be needed to recover a satisfactory trading position. Unfortunately, the existing management team may be slow to realise the true position and reluctant to seek outside advice. This is often because their outlook will be positive, believing that they can "grow" the business out of its difficulties. They may be correct, but the concerned stakeholder will want to know exactly how this will be achieved. After all, the Chief Executive and Board are responsible for the current business plan and if the business is consistently failing to hit budget, something is fundamentally wrong. The smart move in these circumstances is to seek independent advice.



If the situation is really critical, an independent business review will be required by the company's bankers but it is far more useful to take action before that point is reached. If the company pro-actively appoints its own independent advisers, this will be viewed positively by the banks and may also prove an effective strategy to avoid or repair a breakdown of trust between the Board and its stakeholders. Given that a highly specialised skill set is required when a business is in trouble, it is important to ensure that the right advisers are appointed. A good place to begin that search is with the Society of Turnaround Professionals who will be able to suggest a choice of experienced professionals who may be suitable for the assignment.

In addition to dialogue with the management team and other stakeholders, the turnaround professional will examine a range of performance measures to gauge the situation and the prospects of recovery. As an independent observer, they are better placed to rigorously test the robustness of the business plan and the assumptions on which it is based. It is their responsibility to report frankly to the Board on the actual position and the validity of any existing recovery plan. Having undertaken the review, the turnaround professional will indicate potential options for recovery. If recovery is achievable, they may recommend the specific individuals or team that can assist with that recovery.

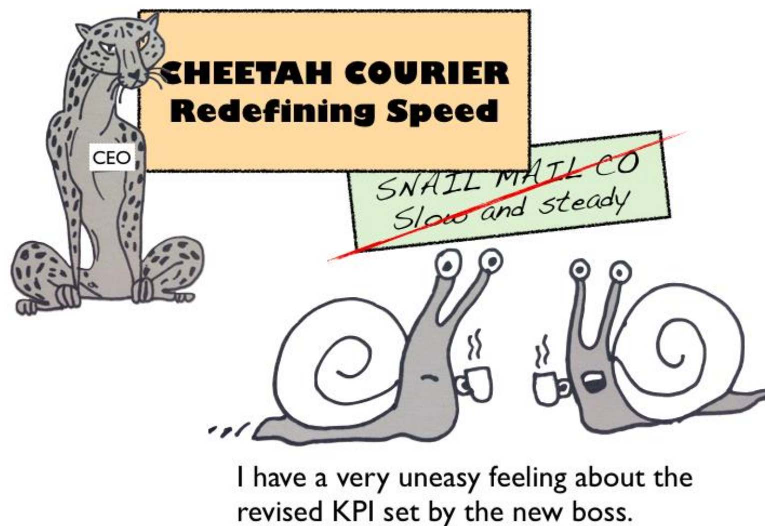
It is important that existing directors and stakeholders understand why these additional resources are required. A business in crisis has to undertake a whole range of specialist activity. For example, bank negotiations can be extremely time consuming, as can managing the cash flow and re-negotiating terms with suppliers. The existing management needs to be running the business. Management do not have the time for other specialist tasks and may well lack the experience or contacts to undertake serious restructuring.

Early intervention can be a vital factor in securing a company's future, so it is important to know at what point it is time to seek outside help. As a guide, unless there are some obvious mitigating circumstances, if a company has failed for several consecutive months to achieve budget, this is a signal to seek some independent advice especially if, in line with the measures outlined later, the business is not competing effectively with similar operations. It is neither an admission of failure nor a sign of weakness for a company to seek specialist advice in these circumstances. It is simply making sure the company has the right resources available for the challenges it faces.

Measuring Performance

These are some of the key measures used to assess business health. Bear in mind these are most useful as indicators when compared to competitors.

These measures are in addition to the Key Performance Indicators ("KPIs") that a firm should have developed to assess its performance on a weekly and monthly basis.



I have a very uneasy feeling about the revised KPI set by the new boss.

Capital Gearing Ratio is Long Term Debt divided by Total Capital (i.e. long term debt + shareholders' funds) and indicates the proportion of debt in relation to shareholders' funds. A company with a high gearing ratio is more vulnerable to a downturn in trading, since debt-servicing obligations must still be met out of lower profits, while the profits available for dividends to shareholders will reduce in proportion.

Cash Conversion is the ratio of operating cash flow to operating profits. Ideally, this should be a high percentage. A low percentage is often due to unsold stock and an increase in receivables.

Creditor Days (accounts payable divided by average daily credit purchases) and Stock Days (stock value divided by average daily cost of sales) are useful measures of how well working capital is being used. An increase in Creditor Days may indicate poor management of working capital (e.g. slow debt collection) or inability to obtain long-term finance.

Current Ratio is current assets divided by current liabilities and indicates how easily payments to short term creditors can be met from readily convertible assets (stocks, accounts receivable, cash). A ratio of less than 1 is plainly undesirable. In some businesses, such as manufacturing, stocks may not be readily convertible.

Debt: Equity Ratio is calculated as Total Liabilities divided by Shareholders' Funds. As a general guide, 0.5 may be considered a safe limit although there are many companies that successfully operate with a higher debt ratio. However, as with all financial ratios, comparison with other firms in the industry, and over time, provides a better indicator of corporate health.

Debtor Days (accounts receivable divided by average daily credit sales),

Earnings Before Interest and Tax ("EBIT") is calculated as Sales minus Cost of Sales less Operating Expenses. EBIT is more useful as a comparative than the bottom line Net Profit, because it excludes two main items that are not related to operational performance: interest payments relate to financial structure, while the level of taxation is determined by factors external to the business. This is also referred to as PBIT (Profit Before Interest and Tax).

Earnings Before Interest, Tax, Depreciation and Amortisation ("EBITDA") is EBIT with depreciation and amortisation charges added back. These charges relate to the accounting treatment of past capital expenditure, whereas investors are interested in current and future performance. By excluding depreciation, which is a non-cash expense, EBITDA is also useful as a measure of underlying cash flow.

Earnings Before Interest, Taxes, Depreciation, Amortization and Rent ("EBITDAR") is EBITDA with rent added back. This is particularly appropriate for any business, such as retail, that lease the space they trade from where rent can be a major operating cost.

Earnings Before Interest, Taxes, Depreciation, Amortization and Rent Adjusted ("EBITDARA") is 'EBITDA adjusted to replace the lease rent charge required under International Financial Reporting Standards with the actual lease rent payable for the period in question to produce a close approximation of 'cash' EBITDA. A company's accounts can often be flattered where it has benefitted from rent free periods and the underlying cash outflow can be greater than the rent recorded as payable in the accounts. This will significantly overstate underlying long term profitability. However, once the rent free period is concluded this better reflects long term cash profitability, otherwise adjustments of this sort are hidden in working capital

Key Performance Indicators ("KPIs") measure how an organisation performs an activity that is critical for its current and future success. The critical activity doesn't necessarily need to be a single activity; it could be operational, tactical or strategic in nature. It is said that what gets measured, gets done. KPIs help define and measure progress toward achieving objectives.

Quick Ratio (also known as the Acid Test), excludes stock from current assets. For companies with a fast stock turnover, a ratio of less than 1 may be acceptable. (Note that liquidity ratios can also be too high, suggesting overinvestment in working capital.)

Return on Capital Employed ("ROCE") is the percentage of EBIT to Capital Employed (i.e. shareholders' funds + overdraft + long term creditors + provisions). It is a measure of how well the management is using the company's capital resources to generate profits for investors. As a rule, investors want to see a figure that is higher than the return they could get by investing their funds in a bank savings account (which carries reduced risk).

Return on Sales ("ROS") is EBIT divided by Net Sales. It shows the amount of profit generated by each pound of sales, and measured over a period time is a useful indicator of operational efficiency. ROS varies widely between industries. For example, grocery retailing has a relatively low ROS because the business is heavily dependent on volume. ROS is also known as profit margin.

Revenue per Full Time Employee (FTE) measures the sales generated per full time employee. This is a measure of productivity of company's personnel. A very high number can show a very efficient business or one where sales are inflated. Along with all ratios it needs to be read in comparison with its peer group. It is also worth comparing the revenue per FTE to the average wage per employee.

Shareholders' Funds is share capital plus retained profits.

Staff Turnover Rate is calculated by dividing the number of employees who left by the total number of employees at the beginning of the period. This number is expressed as a percentage. You can calculate voluntary turnover, involuntary turnover, and total turnover.

Ian Gray is one of the most respected Turnaround specialists working today. He has extensive international experience of business recovery in wide-ranging assignments. Ian's boardroom experience includes numerous PLCs and spans many different industry sectors, including: apparel, biotech, construction, distribution, electronics, engineering, FMCG, healthcare, leisure, manufacturing, media, property, retail, telecoms and travel. He is a Fellow of the Institute of Chartered Accountants; a Fellow of the Institute for Turnaround; Founding Member of the Asian Transformation and Turnaround Association. He holds the Corporate Finance Qualification, is a Chartered Manager; and a Fellow of The European Association of Certified Turnaround Professionals. Over the last two years he has won three prestigious business awards for his work.

Ian is based in both London and Hong Kong.

Ian.gray@baronsmeadconsulting.com

Quin SQ Thong has extensive experience in finance, operational management and business strategy. She specialises in corporate strategy and operational excellence and helps transform her clients' performance in three areas: profits, people and productivity. Previously Quin held CFO and COO positions in multi-national companies and in a Big Four accounting firm, having worked in South East Asia, Hong Kong, China, Taiwan, Australia and London. She speaks on leading management practices, leadership, financial insights and strategy at forums and conferences.

Quin is a visiting lecturer on business strategy and leadership at MBA schools in China. She is a Chartered Accountant, MBA and speaks Cantonese, Mandarin, English and Bahasa.

Quin is based in Hong Kong and Singapore.

quin.thong@baronsmeadconsulting.com

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