THE INTERIM CHIEF FINANCIAL OFFICER

Financial Benchmarking and Modeling – They Always Forget The Important Part

Trinity
Consulting Group International, LLC

INTRODUCTION

The ability to successfully manage a company is directly dependent on the financial tools owners and senior managers effectively use.

Relatively easy to use financial models permit owners and managers to establish short-term and long-term financial goals to successfully manage the business. Not only do these financial models provide a road map for success, they also provide feedback to determine when adjustments need to be made when unexpected and usually unavoidable detours are encountered. The main problem for many companies is that senior management fails to use these techniques, or only uses selective elements when all are required to work together. To successfully manage a growing business, benchmarking, modeling, and variance reporting are continuously required.

CLASSICAL BENCHMARKING STUDIES

Benchmarking is classically defined as the practice of identifying another business that is regarded as the best in its class and learning as much from it as possible. Of course, the process is an attempt to import these best practices into your organization so as to dramatically improve your processes and, in theory, your organization. The term was popularized in the 1980s by Xerox Corporation's Robert C. Camp who wrote the first major book on the subject: *Benchmarking: The Search for Industry Best Practices that Lead to Superior Performance*.

Classical benchmarking involves a measure of cooperation between two companies that become benchmarking partners. Whole industries have sprung up around the concept with the American Productivity and Quality Center (APQC) leading the way beginning in the early 1990s. While primarily manufacturing driven, its methodologies have been expanded over the years to cover a broader range of best practices covering industries beyond mere manufacturing firms. Classical benchmarking has been credited with improving performance by studying specific business or manufacturing functions (functional benchmarking), general industry characteristics (industry benchmarking), general strategies (tactical benchmarking), the numerical characteristics of specific products or processes (performance benchmarking), or general business practices that are not industry specific (generic benchmarking.)

The main problem with classical benchmarking is that it has little usefulness or practicality for SMEs.[1] The two primary reasons are cost and timeliness. Small businesses typically are not willing to pay for such a study and do not have the time or manpower available to conduct the study. To the extent they do any studies, it is often quite random and of negligible usefulness.

It has been our experience that most small businesses lack the resources or owner know-how to conduct even rudimentary research that may have a very positive impact on their business profitability. For example, when we interviewed a multi-store retailer about its customer base, we only received general answers about where customers were coming from or where competitors were located. Simple tactics like asking each customer their address or zip code and plotting them on a local map seemed as foreign a concept as did plotting their competitors on the same map. Obviously, this information could prove quite valuable in properly directing scarce advertising dollars as well as future expansion potential.

PRACTICAL BENCHMARKING STUDIES

As may be surmised, we are not fans of classical benchmarking for either small or mid-sized businesses and we do not advocate such studies for our clients. However, for mid-sized businesses we have found that a practical financial benchmarking study combined with the development of a four quarter rolling financial model and subsequent cash variance analysis provides an enormous boost to business profitability and business owner peace of mind. In nearly every engagement, whether solely for the delivery of a benchmarking study and financial model, or as part of the initial interim chief financial officer[2] engagement, we conduct these analyses. The practical insights for the business are priceless.

The critical issue in providing these services is that other firms consistently omit either Part One or Part Two in an attempt to appease clients or reduce cost. In our opinion, a financial benchmarking study is worthless without a financial model of the business. Likewise, a financial model of the

> *In our opinion, a financial benchmarking study is worthless without a financial model of the business. Likewise, a financial model of the business is worthless without the underlying data provided by the financial benchmarking study.*

[1] While there are no consistent definitions of Small to Mid-sized Enterprises (SME) in the United States, we generally define a small business as one with under 25 employees and $10 million in annual revenues and a mid-sized business as one with between 25 and 250 employees and between $10 million and $50 million in annual revenues.

[2] Sometimes referred to as an outsourced, part-time, fractional, acting, or interim chief financial officer.

business is worthless without the underlying data provided by the financial benchmarking study.

PART ONE: BENCHMARKING THEORY

In practical benchmarking we are not looking at a process or segment of the business to determine improvement by comparing those processes or segments to some partner company. Rather, we analyze the entire business and each of its functional units (e.g., sales, marketing, operations, accounting, management, etc.) and then compare them to industry standards to find weaknesses and areas of underperformance. We then analyze those weaknesses and underperforming areas based on industry standards and our proprietary models. Once problem areas are identified we then move to Part Two of the process: development of a financial model with built-in feedback loops and a written implementation and follow-up plan.

PART ONE: BENCHMARKING METHODOLOGY

The size and complexity of the company usually dictates whether a single-step or multi-step process is undertaken. Generally, mid-sized enterprises of under $25 million in annual revenues and 50 employees engage in a single-step process where all functional units are benchmarked during a single process. The single-step process is usually handled in two-to-three days of on-site interviews and observation, with a one-to-two day follow-up session typically 30 days thereafter. Larger organizations typically break down the benchmarking process into two-to-three single-step processes that may, or may not, operate concurrently. In any event, whether single-step or multi-step, the methodology is the same with the only difference being the number of functional areas reviewed at any one point in time. Given the somewhat disruptive nature of the process, larger organizations typically elect to undergo a series of single-step processes on mutually identified functional units.

Based on our work with SMEs, the following functional areas are usually identified and benchmarked:

- Accounting/Administration
- Sales
- Marketing
- Inventory/Warehouse
- Operations
- Management/Owners

While these are somewhat generic classifications, nearly all SMEs have the same functional units with some minor level of differentiation depending on the business (e.g., manufacturing vs. wholesaling vs. retailing.) Businesses with multiple locations also need to be taken into account in the review and timing. It should be carefully noted that no study is complete unless management/owners are included in the functional unit mix.[3] The entire process typically takes about 60 days to complete.

A critical component of developing a relevant benchmarking study is identification of meaningful and applicable data from similar firms. We do not advocate finding a "best practices" partner; rather we attempt to locate a relevant sampling of similar businesses in order to develop a range of values for comparison purposes. For example, if our client is in the home remodeling business within a specific geographic region, we will attempt to identify a statistically meaningful number of similar businesses in order to compare financial results of operations and other identified criteria. There are a number of databases that provide such services stratified by industry, geography, size, etc. This data provides insight regarding how well our client is performing compared to similar businesses.

To the extent available, we also look to trade associations for comparable business statistics and operating data. We find that this data is usually readily available and is typically superior to other databases.

We then combine such independent database and trade associ-

[3] *Please refer to our other publication "The Problem is You!" for our rationale.*

ation data and compare it to our client data for an initial review of outliers. Further, we use our proprietary metrics and experience to provide further insight into potential areas requiring examination. Problem areas that require remediation are usually readily apparent. For example, our engagement by a $15 million business engaged in specialized construction clearly indicated that commissioned salespersons were overcompensated by 2% of net revenues, installers were overcompensated by 1.5% of net revenues, and various other general expenses were excessive by at least 1% of net revenues. Consequently, an additional $675,000 could be brought to the bottom line through contract renegotiation and adequate cost controls.

PART ONE: BENCHMARKING RESULTS

The results of our investigation are compiled and presented to the client in a comprehensive written format that discusses our methodology in detail, the areas of the business that in our opinion require modification, our specific recommendations for fixing the problems in order of priority, a projected timeline, and our suggestions regarding how we can provide ongoing help and assistance.

THE CRITICAL GAP

The benchmarking study is only as useful as there are tools available to guide company change and a feedback mechanism to reinforce that change. Consequently, a rolling four-quarter financial model is also included that builds on the findings of the benchmarking study, projects what the company should look like on successful implementation of the recommended changes, and finally provides a feedback loop to management to re-direct efforts toward those areas that require further work. This financial model is the subject of Part Two of this publication.

We often encounter clients that desire the delivery of a financial model, sometimes known as a budget, but omit the benchmarking study. Alternatively, we also find clients that initially desire a benchmarking study, but omit the financial model. Lastly, we are often engaged to repair company budgets because a predecessor (internal or external) failed to provide on-going variance reporting for the financial model. All three of these, the benchmarking study, the financial model, and the cash variance report, are critical components of a complete company analysis and provide the framework for profitable management. Failure to complete any one element makes the entire project a waste of corporate resources.

All three of these, the benchmarking study, the financial model, and the cash variance report, are critical components of a complete company analysis and provide the framework for profitable management. Failure to complete any one element makes the entire project a waste of corporate resources.

PART TWO: MODELING THEORY

Once the benchmarking study is complete, the company's operations should be clearly identified and any problem areas prioritized. For most companies we find that the accounting department is delivering a rudimentary monthly budget and variance report to management based solely on the capabilities found in their accounting software package. Typically this includes delivery of a monthly and year-to-date profit and loss statement based on the company's chart of accounts and includes columns for actual, budgeted, and variances reported monthly and year-to-date. We have seen these analyses comprise several pages of detailed numbers.[4] In private sessions with company owners we have directly inquired about their level of understanding of this analysis. Nearly without exception owners state that the analysis is confusing and then proceed to inform us regarding how they really manage the business. For most SMEs, we find there is a major disconnect between the accounting department, senior management, and line managers.

Two related areas provide quite a bit of complexity to the process. First, in order to simplify the model, often balance sheet items are omitted. Second, in order to further simplify the model, often a cash-basis approach is taken rather than an accrual-basis approach. These simplifications can have detrimental effects on the model.

We generally start with the manner in which the company prepares its accounting records and then adjust such records as properly suits the model output desired by management. By doing so, the variance reporting is simplified since it ultimately is derived from the accounting records and can be quickly developed within days of the monthly close.

PART TWO: MODELING METHODOLOGY

Generally company management is primarily concerned with managing its profit and loss statement. Consequently, we first concentrate on preparing a minimum twelve-month accrual-based budget with revenues and cost of goods sold segmented by product line and overhead expenses separated into fixed and variable costs. Some clients prefer to also separate out employee selling and administrative compensation costs, especially if these costs are material expenses.

The profit and loss statement is summarized as follows:

Revenues	
Segment #1	$ XX,XXX.XX
Segment #2	$ XX,XXX.XX
Segment #3	$ XX,XXX.XX
Other revenues	$ XX,XXX.XX
Gross revenues	$ XX,XXX.XX

Continued on next page...

[4] *See Appendix 1 for a redacted example of a typical company-prepared P&L and budget.*

...continued from previous page

Cost of Goods Sold	
Segment #1	$ XX,XXX.XX
Segment #2	$ XX,XXX.XX
Segment #3	$ XX,XXX.XX
Total cost of goods sold	$ XX,XXX.XX
Gross Profit	$ XX,XXX.XX
Selling, General and Administrative Expenses	
Employee overhead compensation costs	$ XX,XXX.XX
Fixed costs	$ XX,XXX.XX
Variable costs	$ XX,XXX.XX
Total selling, general & administrative expenses	$ XX,XXX.XX
Earnings Before Interest, Taxes and Depreciation (EBITDA)	$ XX,XXX.XX
Depreciation and amortization	$ XX,XXX.XX
Earnings Beofre Interest and Taxes	$ XX,XXX.XX
Income taxes	$ XX,XXX.XX
Net Income (Net Loss)	$ XX,XXX.XX

One of the most important features of the financial model is its interactivity with users, typically used for developing what is commonly known as "what if" scenarios. The real usefulness of the model is its ability to change the assumptions underlying the main premises to observe the corresponding results and impact on the business operations. For example, what effect does an X% decrease in cash inflows have on the bottom line. Or, what effect does an X% increase in compensation costs have on the bottom line.

PART TWO: MODELING RESULTS

The primary result is to deliver a set of highly intuitive and interactive models that seek to explain in detail the company's future operations under an unlimited set of scenarios. This permits senior management to, first, decide upon a specific course of action for the next period (typically twelve months) known as a "Plan" and, second, to change the "Plan" on a periodic basis (typically quarterly) known as the "Forecast." The Plan keeps senior management's initial vision for the future firmly in view, while the Forecast allows senior management to adapt to changes brought about by changing market conditions. The Plan and Forecasts are the company's budget and feed into the projection of the company's financial statements.[5]

[5] *See Appendix 2 for a redacted example of the main summary page of a budget.*

PART TWO: VARIANCE REPORTING

The financial benchmarking study provides the underlying data for development of the financial model. The financial model provides the interactive tools for internally managing the business on a month-to-month basis and for the development of projected financial statements for external users. However, without a feedback mechanism, the results are just numbers and, as previously mentioned, not useful to owners or senior managers.

Monthly variance reporting provides the feedback mechanism for senior management to manage the business.

Monthly variance reporting provides the feedback mechanism for senior management to manage the business. Since the variance reporting is mapped to the company's accounting software chart of accounts, rapid data download is easily achieved after monthly close, permitting rapid completion of the monthly variance report. The variance report compares the monthly actual results of operations to the monthly and year-to-date Plan and Forecast.[6]

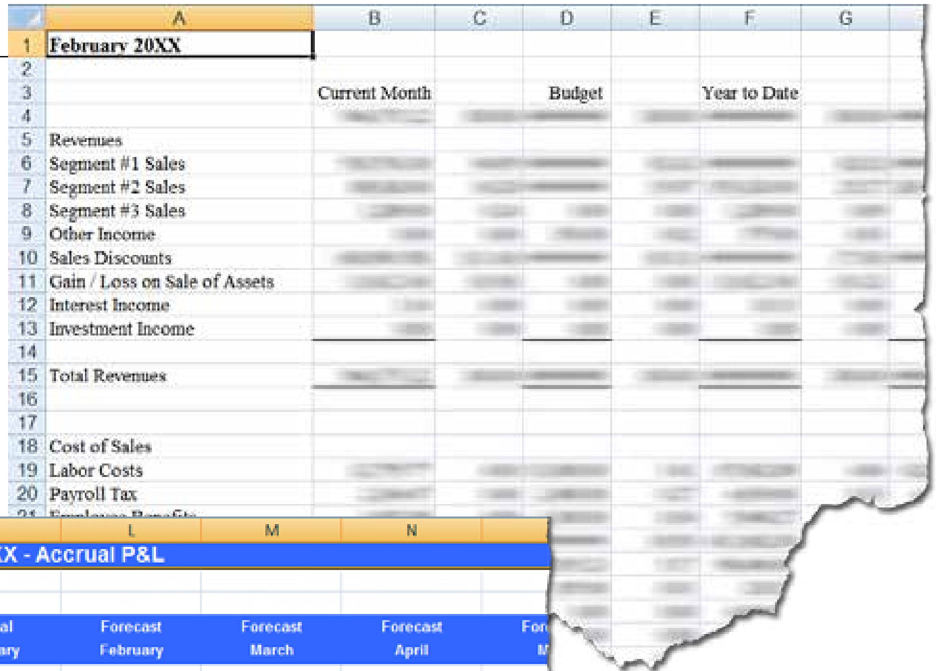
We typically advise owners to schedule monthly open-session senior management meetings to discuss the results of the variance analysis, with each department head reporting on their monthly results. The framework for the discussion is obvious: what did we plan to do (the "Plan"), how have we changed our plans (the "Forecast"), how did the results of operations compare to the Plan and Forecast (the "Variance Report"), and what changes do we need to make to get us back on track. Constant referral back to the Plan prevents the Forecast from degrading over time, with the Variance Report providing the monthly data.

PUTTING IT ALL TOGETHER

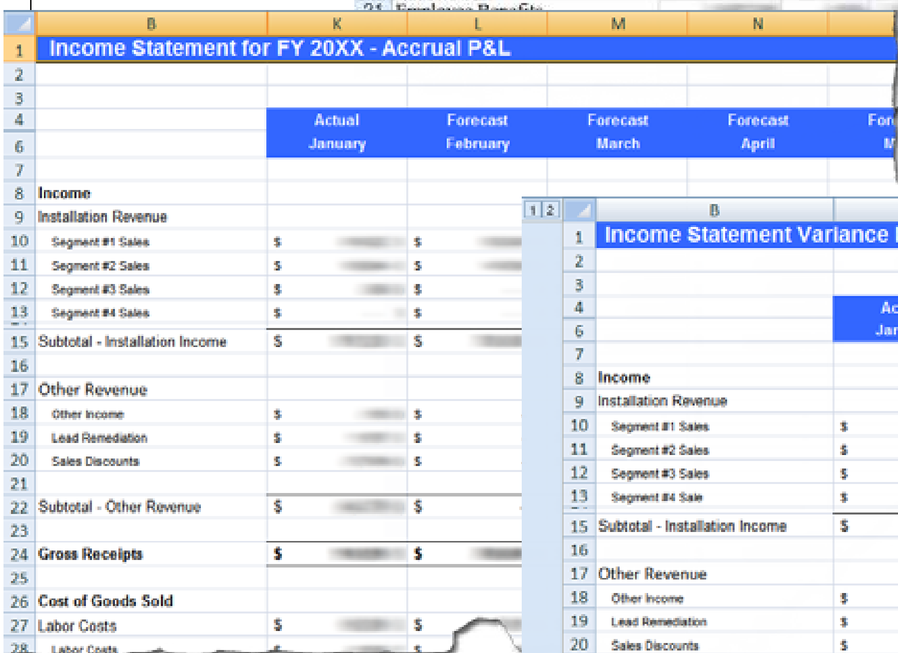
Proper utilization of financial benchmarking, modeling and variance reporting can significantly assist owners and senior managers in identifying successful growth strategies that positively affect the company's bottom line. Even in hyper-growth or turnaround situations, these tools are extremely useful in identifying and controlling costs associated with such growth and ensuring that owners and managers are all working together to achieve common and reasonable financial goals. While these tools do not purport to ensure economic success, they provide the roadmap of what success looks like and the rapid feedback mechanism to alert everyone when an element of the business requires immediate attention.

[6] *See Appendix 3 for a redacted example of a monthly variance report.*

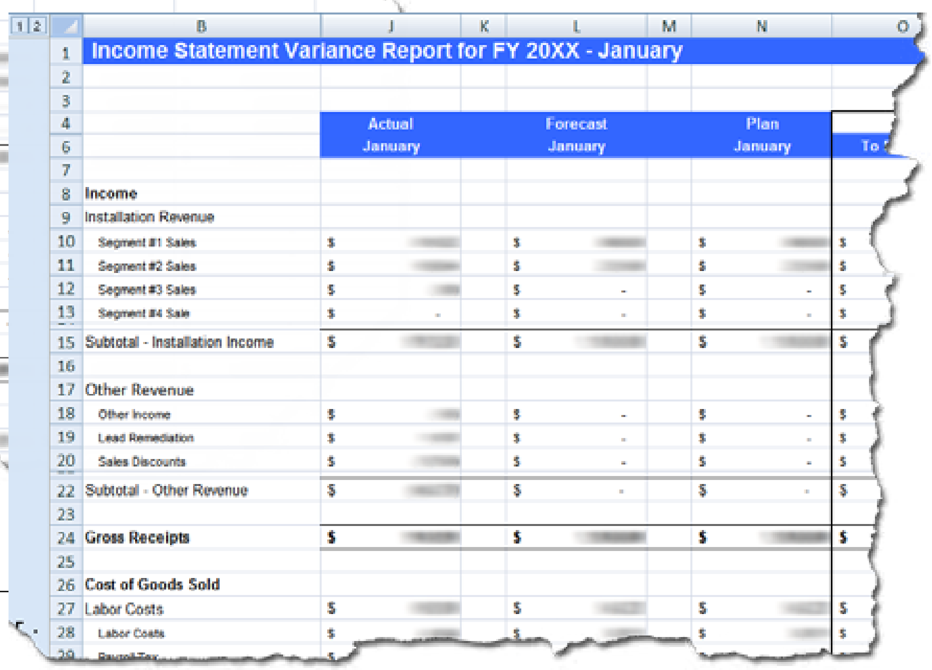
Appendix 1
Typical company-prepared P&L and budget



Appendix 2
Main summary page of a budget



Appendix 3
Monthly variance report



A GENTLE PLUG FOR OUR FIRM

With offices in Washington, D.C., Trinity Consulting Group International, LLC has provided a broad range of financial advisory and interim CXO level services to dozens of clients in multiple industries since 1998. Whether you require short-term assistance or an ongoing management partner, we have the experience and expertise to help ensure your financial and business success. In all of our services we emphasize thoroughness of preparation, professionalism in execution, and effectiveness in assisting you in meeting business objectives.

For more information please contact us:

Voice 703-585-0615

Web http://www.T3International.com

Email info@T3International.com
