KPIs Can Assist in Managing Bank Concerns

By Jonathan C. Daiker, CPA

Many companies get sideways with their banker and believe it's the bank's problem. But given careful scrutiny, they will come to realize, that in addition to the concerns of their banker, they have *real* business problems. Why does this happen? It occurs because management doesn't have realistic key performance measurements (**KPIs**) and in many cases, does not have measurements at all! Rest assured your banker has measurements in place to identify, early on, problems that may impact your ability to repay your outstanding loan balance and to also identify conditions that may cause a default on your loan agreement accelerating repayment.

KPIs provide insight into your business performance -- "What gets measured, gets managed". KPIs are also known *as* performance metrics, business indicators, and performance ratios. They can relate to all aspects of your business - operational performance, functional efficiency, asset utilization, employee efficiency. The KPIs your banker most closely connects to are related to your operational performance, measured in various terms within your income statement, and your asset utilization, depicted in your company's balance sheet, and the resultant cash flow issues documented at this high level. These overall aspects of your business are readily available through monthly or quarterly financial statements. Since management has a greater need for insight into the business, you will more likely measure the drivers of operational performance as opposed to the high level end result.

From an income statement perspective, some of your banker's key areas of interest are:

- Revenue or Change in Revenue (last period, last year same period)
- Gross Margin %
- Gross Profit %
- Operating Expense expressed as a % of Revenue
- Operating Income

Your banker will look at these items from a trend line perspective, comparing previous periods as opposed to viewing each in isolation. Receding revenues and static or increasing expenses are a sure fire way to set off your banker's alarm. Greater interest and requests for more in depth information will soon follow. This is not necessarily bad, particularly if you can respond quickly as you may be tracking many of these drivers yourself.

A quick response will let your banker know that you are on top of your business and will serve as an initial shot of confidence in management and the company. Although concerned, your banker's approach may be to listen and learn as management has demonstrated they are aware and dealing with the issues.

On the other hand, if you can't respond immediately, you cannot expect your banker to walk away without getting a better understanding of the issues. Furthermore, you can anticipate an aggressive approach as your banker will have opinions on the issues and the course of action. No clear cut answers – this is how you end up sideways!

Obviously, the quick response mode is the way to go. If you're currently not in that position, evaluate your business and begin to develop KPIs both at the high level, as well as at the driver level. This approach will give you a clearer picture of your business performance, in addition to helping anticipate your banker's concerns. If you don't have the time or staff to do the analytical work, there are firms available to assist in the development and implementation of operational KPIs. These are dollars well spent as you gain new insights into your business, helping you take corrective action before issues arise……..and find your banker breathing down your neck!

KPIs can also be used to measure asset utilization - another area of keen interest to your banker as what is happening on your balance sheet can often have a significant impact on cash flow. Cash flow is very near and dear to your banker's heart! It should be near and dear to management as well, as stagnant or slow turning balance sheet items can be costly from an operational as well as interest perspective.

Let's examine a few of the more critical balance sheet items that may show strong signals of business issues. Here again, your banker may be using some high level KPIs to get a sense if there are areas of concern. Current ratio and quick ratio are two that give an indication of how well your company is positioned to meet upcoming obligations. A more in depth look would include: cash and cash equivalents as a % of total assets, net accounts receivable as a % of total assets, long term assets as a % of total assets, current liabilities as a % of total liabilities, maturities coming due on long term debt. Major changes in any of these categories would be a red flag to your banker and would probably trigger a request for more information.

There are KPIs that can assist management in monitoring changes in these balance sheet items. Within the accounts receivable category, management should be monitoring day sales outstanding (DSO) as well as developments in terms of the accounts receivable aging. You might want to take these analyses a step further and compare your accounts receivable data to industry standards as well as to cyclical trends within your business. If your aging is deteriorating you may want to review your customers' terms and adjust them to shorten the collection cycle of outstanding balances.

Inventory on hand can also signal some significant business issues. A growing inventory in times of declining sales can tell management that production may need to be curtailed. Inventory may also be growing because the wrong products are being produced. This can only be determined by performing an in depth analysis of on hand items and identifying those items that are stagnant in terms of current sales. An increase in slow moving or obsolete inventory is a problem that can become costly from a cash flow perspective.

Depending on the industry, there is a plethora of KPIs that companies use to measure the effectiveness and efficiency of getting merchandise to market.

A few other asset areas that can have cash flow implications include investments and fixed assets. These areas often get lost in the shuffle because they are viewed as sunk costs. They need to be reviewed periodically to ascertain that investments are meeting their objectives. If not, plans need to be made to turn them around or if a turnaround seems unlikely, the investment should be divested. Likewise, you may have idle land or obsolete equipment. These assets can be sold and the resultant cash used to reduce outstanding loan balances.

Current liabilities, items that need to be paid in the current business cycle, also have major cash flow implications. Your banker will view current liabilities as a double edged sword. If suppliers and others are not paid on a timely basis, this could negatively impact the continued source of goods and services needed in the production cycle. On the other hand, if suppliers are paid there may not be cash available to pay down loans coming due in the current business cycle. A major increase in current liabilities as a % of total liabilities may be a forerunner to the company's inability to meet current obligations. The current and quick ratios may be a better indication and should be monitored on a continuous basis.

KPIs are an effective way to stay on top of business developments. Not only do KPIs signal management that decisions need to be made but if measured effectively, they will generally point to the business area that needs to be calibrated to respond to developing issues. Staying out in front of your business issues not only serves management well in terms of keeping the business running smoothly but also alerts you to potential concerns and questions that may be forthcoming from your banker. KPIs can also be used effectively in business planning and budgeting and can be an immediate confirmation whether you are meeting your originally planned business objectives.

Throughout this article, your banker has been depicted as being inquisitive about how your management team is running the business. If you have done your home work and developed the KPIs to give you insights into your business, you can respond to your banker's inquisitiveness effectively and with confidence, minimizing the effect of those so called "bank problems".

Many of the KPIs referred to in this article are high level indicators. To be effective as a management team, the drivers are the items that need to be measured as they will isolate the areas where decisions need to be made. There are numerous KPIs and measurement formulas available by industry. If you're uncomfortable in developing these business tools or don't have the internal resources to do so, there are external resources available - it is money well spent!

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