

## A SCORECARD FOR SMALL BUSINESS PERFORMANCE

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### ABSTRACT

*Evaluating organizational performance of small businesses has frequently been a neglected managerial function. When evaluation efforts have been undertaken, they have ranged from simple internal reviews to complex and often costly audits conducted by independent parties. However, most individuals working in a small business rarely take the time or make the effort to undertake a comprehensive review of their business activities. To begin the process of answering the important question of how well a small business is performing, a straightforward approach that is easy to prepare and interpret on a regular basis is required. Realizing that most individuals involved with small businesses are pressed for time, an easy-to-use evaluation instrument designed to focus attention on strategic performance indicators (SPIs) has been developed. These SPIs focus attention on the primary functional areas of a business: management, marketing, and finance. Each question has been designed to help the reviewer think about the importance of strategic performance indicators to the overall success of the business.*

### INTRODUCTION

Evaluating overall organizational performance has long been recognized as an important (Eccles & Pyburn, 1992), but often neglected, managerial function. When evaluation efforts have been undertaken, they have ranged from simple internal reviews to complex and costly audits by independent parties. Unfortunately, many individuals associated with small businesses rarely take the time or make the effort to undertake a thorough performance review. Typically, performance reviews and audits have focused on evaluating the financial area, but they can be equally appropriate and effective in identifying the need for improvement in other functional areas of a business (Bogan & English, 1993). However, the literature appears to be devoid of an easy-to-use, yet comprehensive, tool that will meet small business needs. In response to this void, a performance evaluation instrument was specifically designed to be used in a small business setting.

To serve the needs of small businesses, an evaluation instrument should be both universal and comprehensive in nature. It should contain common elements found in other traditional performance evaluation formats such as management audits, marketing audits, and accounting audits. The performance evaluations to be conducted in any one functional area should not be considered mutually exclusive or unrelated to those in other functional areas, since all business activities are inextricably intertwined. Evaluations should be designed to

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highlight the interrelatedness of all business activities in an attempt to achieve the ultimate goal of striving for continuous quality improvement.

Small business evaluation instruments should be designed with a balanced approach in mind. To preserve their usefulness, they should be of limited scope and focus on strategic performance indicators (SPI) within the three primary functional areas of a business: management, marketing and finance. SPIs must be activities that are both under the owner's or manager's direct control and which can be modified to result in improved efficiency and/or effectiveness. Therefore, selected SPIs in an evaluation instrument should focus on key procedures, practices or sets of data; be comprehensive in nature; and provide an opportunity for timely corrective action.

The proposed scorecard, based on a simple "yes/no" dichotomous design, may err on the side of simplicity, but it was developed to encourage use by a broad range of interested parties from sole proprietors to small business consultants. The comprehensive overview of key business activities encourages users to think about linkages among the functional areas reviewed. Although these questions pre-suppose some basic knowledge of business principles, practices and terminology, they have been crafted to be "user-friendly." Those individuals using the scorecard who have not acquired a general knowledge of business subjects through education or experience might need assistance completing the evaluation process the first time.

This performance evaluation scorecard, developed specifically for small businesses, uses the balanced viewpoint approach proposed by Kaplan and Norton (1992). Individuals interested in performance evaluation formats suitable for large businesses should see Kaplan and Norton (1992).<sup>1</sup> The questions presented in the proposed performance scorecard (see Appendix A) are designed to be general in nature, yet limited in number to encourage periodic use and focus on business practices that can promote improved performance. These questions focus attention on a variety of activities and measures ranging from planning and performance processes to key strategic variables. They enable the user to easily identify significant trends. They also emphasize the important, but often overlooked, task of continuously gathering information critical to the future success of the business.

It is important to note that the "yes/no" answers are not designed as an end in themselves, but as a guide to focusing attention on organizational performance and ways to improve that performance. Either a positive or negative response to a question may indicate the need for corrective action and/or further analysis depending on the SPI being evaluated. The "Action Required" column allows the user to document future actions. Some questions, by their very nature, could guide the user to take immediate corrective action, while others may require additional information and analysis.

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<sup>1</sup> Kaplan, Robert S. and David P. Norton. (1992). The balanced scorecard - measures that drive performance. *Harvard Business Review*, 70(1), 71-79.

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## **SPIs OF A MANAGEMENT REVIEW**

Reviews of management performance have typically been designed for large organizations and have been conducted by: 1) evaluating qualitative performance standards; 2) comparing accumulated performance data to planned quantitative objectives; and/or 3) conducting surveys. Due to the importance of qualitative and quantitative strategic performance indicators, both were incorporated into this scorecard. Surveys were not selected for inclusion in this evaluation instrument due to financial and time constraints facing most small businesses. However, surveys may be used on a less frequent basis to validate perceptions and findings obtained from the completed scorecard.

Brossy (1986) outlined several qualitative and quantitative performance measures for assessing chief executive officer (CEO) performance. Many of these measures appear appropriate for small businesses and have, therefore, been incorporated in the proposed scorecard. Although many performance criteria could be selected, the four strategic performance indicators included in the proposed scorecard focusing on the functional area of management are:

1. Strategic Direction,
2. Strategy Implementation,
3. Human Resources, and
4. Community/Government Relations.

To assess the presence of an established strategic direction, attention can be focused on the following questions:

1. Has the external environment in which the business operates changed? If yes, have changes been made to align the business with these changes? If no, how will potential changes be monitored in the future?
2. Has a mission statement (the reason for the business's existence) been written? If yes, does it reflect the current vision of the owner-manager? If no, when will this statement be written?
3. Have specific goals been published for the next two to five years? If yes, how much progress has been made toward accomplishing these goals? If no, when will specific goals be identified and recorded?

Once the strategic direction of the business has been assessed, the evaluator can then proceed to reviewing the effectiveness of strategy implementation.

Simply developing a well thought out strategy for conducting business is not enough. These plans must be put into action. Successful strategy implementation requires tying performance measures to desired outcomes (Grady, 1991). The effectiveness of strategy implementation can be assessed by answering the following questions:

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4. Are employees dedicated to achieving the stated goals of the business? If yes, how has this dedication been reinforced? If no, what changes have been planned to improve commitment?
  5. Have procedures been established to insure consistency in quality and quantity of goods/services produced/provided? If yes, do these procedures still reflect the desire to meet and/or exceed customer expectations? If no, have time frames been set to either write and/or update these documents?

Evaluating strategy implementation leads the reviewer to the next SPI - human resource issues.

The strategic importance of human resources to overall business success was highlighted by several authors (c.g., Flamholtz, Searfoss, & Coff, 1988; Grady, 1991; Watts & Ormsby, 1990). Grady (1991) noted the importance of implementing and measuring performance as a means of communicating strategy to employees. Watts and Ormsby (1990) also identified the need for focusing attention on human resource issues in order to achieve organizational effectiveness. Flamholtz et al. (1988) focused attention on the economic value of human resources. Key human resource issues may be evaluated by asking the following questions:

6. Have yield ratios and retention rates been calculated for various recruiting sources? If yes, are the most effective sources being used? If no, are new sources that could be more effective being explored?
7. Have key individuals who are capable of assuming more responsibility been identified? If yes, what type of training have they received or are they scheduled to receive? If no, are plans being developed to retain key employees?
8. Are records maintained on tardiness, absenteeism, accident frequencies, and turnover? If yes, what steps have been taken to improve each of these areas? If no, are plans being made to collect data necessary for equitable human resource decisions?
9. Are performance evaluations and wage and salary adjustment records maintained on all employees? If yes, are productive employees recognized and compensated on a competitive basis and poor performing employees counseled on improving performance and/or dismissed? If no, are plans being made to begin keeping such records?
10. Have employees with extended service been given proper attention and consideration in matters of scheduling, vacation preference, and other available benefits? If yes, is this information being communicated to employees on a regular basis? If no, are plans being made to recognize the relationship between length of service and employment benefits?

The significance of human resource issues was highlighted by Leifeld (1992) who noted that "[a]ggressive quality and performance goals require strong human resource plans and practices to insure that employees' maximum potential is utilized" (p. 51). It is often said that employees are a business' most valuable resource. However, unless this resource is monitored, it may be overlooked and eventually wasted.

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The final SPI in the management area deals with community and government relations. The questions in this series provide an opportunity for the reviewer to consider relationships between the community and the business. These questions have been designed to focus attention on the critical issues of ethics and social responsibility. Community/government relations issues may be evaluated by asking:

11. Have clear guidelines for ethical behavior been communicated to all employees? If yes, how have employees been recognized when their actions support the ethical goals of the business? If no, is a code of conduct that reflects the ethics of the business being formulated?
12. Does the business return value to the community by supporting socially responsible programs? If yes, how have these efforts been communicated to employees and other interested parties? If no, what programs are under consideration for support?

Providing a foundation that encourages ethical behavior and fosters social responsibility creates an environment that benefits the business, the employees, the community, and the customers.

## **SPIs OF A MARKETING REVIEW**

The central role that marketing efforts play in the success of an organization is widely recognized. Bonoma and Clark (1990) noted that managers tend to worry more about marketing issues than those in any other functional area. They also noted that marketing strategies quickly become obsolete regardless of the amount of effort spent on planning and implementation. Therefore, it is important to review periodically the effectiveness and efficiency of a firm's marketing efforts. Although several approaches (Berry, Connant, & Parasurman, 1991; Bonoma & Clark, 1990; Brossy, 1986; Kotler, Armstrong, & Starr, 1991; Walsh, 1990) to reviewing a firm's marketing efforts have been suggested, all agree on the importance of systematically performing this task.

By combining the formality found in the components of the classic marketing audit (Kotler et al., 1991) with those of the service audit (Berry et al., 1991), a concise and comprehensive review of marketing efforts can be achieved. In the functional area of marketing, the three strategic performance indicators included in the scorecard are:

1. Marketing Orientation,
2. Attracting New Customers, and
3. Serving Customers.

The proposed scorecard builds upon the approach and ideas suggested by Berry et al. (1991) to develop questions designed to help reviewers assess marketing performance. Those desiring to perform a more in-depth marketing performance analysis should see Bonoma and Clark (1990).

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The first SPI addressed in the functional area of marketing, marketing orientation, examines the framework a business has laid to serve customer needs. According to Levitt (1960), failure to assess consumer sentiments and the changing environment on a regular basis could result in marketing disasters. It is also vitally important in today's competitive environment to pay close attention to the service element in a business's operations. To assess the current marketing orientation of a firm, it is necessary to answer the following questions:

1. Is marketing research directed at determining customer needs conducted on a regular basis? If yes, have customer responses been incorporated into business activities and/or plans? If no, have plans been made to conduct basic marketing research?
2. Are employees who do not interact with customers aware of how their jobs might influence customer satisfaction? If yes, are efforts being made to improve customer satisfaction? If no, what type of training are they scheduled to receive?

An active marketing research program can be designed to provide reviewers with a realistic assessment of consumer expectations. Although often complex, marketing research activities do not need to be detailed, quantitative exercises. It is, however, critical to collect consumer information on either a formal or informal basis.

Based on an investigation of successful small businesses, Peterson (1992) identified several marketing related factors that were closely associated with success, including consumer oriented goals, positive word-of-mouth publicity and serving customer needs. The effectiveness of a firm's efforts to attract new customers can be determined by asking the following questions:

3. Are formal strategies in place to attract new customers? If yes, has the cost effectiveness of each strategy been assessed? If no, what steps are being taken to identify approaches for attracting new customers?
4. Are employees motivated to sell to prospective customers? If yes, are programs in place to recognize and/or reward these employees? If no, are steps being taken to educate employees as to the value of prospective customers to the future success of the business?
5. Is the organization capable of delivering on the promises made to attract new customers? If yes, are customers being surveyed to determine their level of satisfaction? If no, are steps being taken to ensure service quality?

New customers may not be the lifeblood of a successful business, but they provide an endowment for the business's future growth and success.

The final marketing SPI to be evaluated is customer service. "The nature of the relationship between a small business firm and its customer is, and must be, one of trust" (Humphreys, Robin, Reidenbach, & Moak, 1993: p. 9). This customer orientation can be assessed by asking the following questions:

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6. Are employees properly trained to perform their service roles? If yes, are programs in place to recognize and/or reward these employees? If no, have plans been made to train employees properly?
  7. Are customers offered concrete reasons for doing more business with the company? If yes, how have these reasons been communicated to customers? If no, have steps been taken to identify the reasons customers patronize the business?
  8. Are customers made aware that their patronage is valued? If yes, how is this recognition communicated to customers? If no, how can customers be informed that they are important to the success of the business?
  9. Is sufficient attention paid to solving customer problems when they occur? If yes, are records of customer complaints being maintained so that potential problems in the system can be solved? If no, have plans been made to train employees in customer service recovery procedures?
  10. Do the facilities and communication materials of the organization appear attractive to customers? If yes, have time tables been established to review and update current facilities and offerings? If no, have plans been made to address deficiencies?
  11. Does the organization offer tangible evidence of the quality of its services? If yes, how is quality communicated to customers? If no, what steps are being taken to identify ways of providing tangible evidence of quality?
  12. Do the products/services offered by the organization meet the needs of the customer? If yes, how are these perceptions documented? If no, are steps being taken to identify customer wants and needs?

The inter-connectedness of marketing activities with business resources was highlighted by Larrabee (1988) who noted that evaluating marketing plans in relation to these resources can lead to higher profitability.

### **SPIs OF A FINANCIAL REVIEW**

Although there are numerous financial criteria that could be examined in any business, the following strategic performance indicators have been identified for evaluation purposes since they are the most commonly used (Barnes, 1987; Hermanson & Hermanson, 1994; Lawder, 1989; Yallapragada & Breaux, 1989):

1. Budgeting,
2. Ratio Analysis, and
3. Inflation Adjusted Trend Analysis.

Budgeting is the most commonly used planning and evaluation tool. Budget information allows the reviewer to identify quantifiable objectives and determine if these objectives were achieved (Yallapragada & Breaux, 1989). When reviewing financial performance, a comparison of actual performance with budgeted performance or a predetermined benchmark provides valuable feedback on managerial effectiveness. Budgeting can be evaluated by asking the following questions:

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1. Is a sales budget prepared for each month of the coming year? If yes, is this budget updated monthly to reflect changes in the business environment? If no, what plans are being made to develop this budget?
  2. Is an expense and purchases budget prepared for each month of the coming year? If yes, is this budget updated monthly to reflect significant changes? If no, what plans are being made to develop this budget?
  3. Is a capital expenditures budget prepared for each month of the coming year? If yes, have these expenditures been made to retain a competitive advantage? If no, what plans are being made to develop this budget?
  4. Is a budget of projected cash flows prepared for each month of the coming year? If yes, is it being updated on a monthly basis to reflect changes in levels of business activity? If no, what plans are being made to develop and maintain this budget?
  5. Have performance benchmarks been established for all quantifiable performance measures? If yes, have actual results been compared to budgeted amounts? If no, have competitors or industry sources been identified where these performance benchmark measures can be obtained?

Once the actual results of operations have been compared to the budgeted figures, the reviewer can then proceed to more detailed financial analysis.

The management of cash, accounts receivable, inventories and fixed assets is important when evaluating financial performance and can be accomplished through the use of ratio analysis for predictive purposes. A ratio by itself does not provide particularly useful information. It is only when a ratio is compared with some predetermined standard or the results from previous accounting periods that a true picture of performance can be obtained (Barnes, 1987).

Although dozens of ratios can be calculated, the following four have been selected for financial performance evaluation purposes: return on investment (ROI), current ratio, accounts receivable turnover, and inventory turnover. Appendix 2 provides examples of the selected SPI ratios with accompanying analyses. To assess financial performance, it is necessary to answer the following questions:

6. Has the return on investment been calculated for the most recent accounting period? If yes, has this information been analyzed to determine ways of improving profitability? If no, have plans been made to analyze return on investment?
7. Has the current ratio been calculated for the most recent accounting period? If yes, do measures need to be taken to improve the current financial position of the business? If no, have plans been made to analyze the current ratio?
8. Has the accounts receivable turnover ratio been calculated for the most recent accounting period? If yes, has the average days in receivables ratio been calculated? If no, have plans been made to analyze the accounts receivable turnover ratio?

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9. Has the inventory turnover ratio been calculated for the most recent accounting period? If yes, has the average days in inventory ratio been calculated? If no, have plans been made to analyze the inventory turnover ratio?
  10. Have these ratios been compared to those of past accounting periods, industry standards and/or projected ratios? If yes, do the results meet with your performance targets? If no, what sources for obtaining comparable ratios have been identified?

Ratios have traditionally been used as an evaluation tool to determine a business' financial health (Lawder, 1989). However, inflationary effects on financial performance must also be taken into consideration.

The final SPI examines the effects of inflation on financial performance. A cursory review of year-to-year revenues can often provide a false sense of growing vitality when inflationary growth is being viewed rather than real growth. To determine the real growth of a business, it is necessary to adjust each year to constant dollars, thereby reflecting the impact of inflation. For a complete explanation of these calculations, refer to Appendix 3. The following question should be answered to complete the evaluation process:

11. Has a source been identified for obtaining inflation information that is appropriate for your geographic region? If yes, is this source reviewed on a regular basis? If no, what measures are being taken to locate an appropriate source of information?
12. Have the sales, cost of goods sold, net income and other relevant figures been adjusted to determine the effects of inflation? If yes, have financial performance measures been improving? If no, what measures are being taken to determine the effects of inflation?

By adjusting for inflation, a more realistic picture of a firm's financial performance can be obtained. Although inflation information on a national basis is a good starting point for analysis, it would be more useful to identify a source containing regional or local information.

## **SUMMARY**

The purpose of any type of performance evaluation process should be to review business activities and ensure that performance is as planned. The performance evaluation process also provides opportunities to integrate the functional areas of a business and communicate business strategies throughout the organization. To answer the question of how well a small business is performing, a straightforward approach that is easy to prepare and interpret on a regular basis is required. In this spirit, the authors have developed a scorecard utilizing strategic performance indicators that focus on the primary functional areas of a business: management, marketing, and finance.

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The strategic performance indicators are accompanied by questions which assess current performance levels for the three functional areas. Each question has been designed to provide general guidance to help the reviewer evaluate the strategic performance indicator. The performance scorecard should be completed at regularly scheduled intervals. This allows reviewers to assess performance on a regular basis and use the results for evaluation, control, and planning purposes.

Small business owners and managers may find it especially useful to have their employees complete the performance scorecard. By comparing employee responses with their own responses, owners/managers can determine how much variance or continuity exists between perceptions of performance and actual performance. Performance evaluation provides one more tool in the quest for continuous improvement.

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## APPENDIX 1

### MANAGEMENT PERFORMANCE

		Yes	No	Action Required
<b>STRATEGIC DIRECTION</b>				
1.	Has the external environment in which the business operates changed? If yes, have changes been made to align the business with these changes? If no, how will potential changes be monitored in the future?			
2.	Has a mission statement (the reason for the business's existence) been written? If yes, does it reflect the current vision of the owner-manager? If no, when will this statement be written?			
3.	Have specific goals been published for the next two to five years? If yes, how much progress has been made toward accomplishing these goals? If no, when will specific goals be identified and recorded?			
<b>STRATEGY IMPLEMENTATION</b>				
4.	Are employees dedicated to achieving the stated goals of the business? If yes, how has this dedication been reinforced? If no, what changes have been planned to improve commitment?			
5.	Have procedures been established to insure consistency in quality and quantity of goods/services produced/provided? If yes, do these procedures still reflect the desire to meet and/or exceed customer expectations? If no, have time frames been set to either write and/or update these documents?			
<b>HUMAN RESOURCES</b>				
6.	Have yield ratios and retention rates been calculated for various recruiting sources? If yes, are the most effective sources being used? If no, are new sources that could be more effective being explored?			
7.	Have key individuals who are capable of assuming more responsibility been identified? If yes, what type of training have they received or are they scheduled to receive? If no, are plans being developed to retain key employees?			
8.	Are records maintained on tardiness, absenteeism, accident frequencies, and turnover? If yes, what steps have been taken to improve each of these areas? If no, are plans being made to collect data necessary for equitable human resource decisions?			
9.	Are performance evaluations and wage and salary adjustment records maintained on all employees? If yes, are productive employees recognized and compensated on a competitive basis and poor performing employees counseled on improving performance and/or dismissed? If no, are plans being made to begin keeping such records?			

10.	Have employees with extended service been given proper attention and consideration in matters of scheduling, vacation preference, and other available benefits? If yes, is this information being communicated to employees on a regular basis? If no, are plans being made to recognize the relationship between length of service and employment benefits?			
<b>COMMUNITY/GOVERNMENT RELATIONS</b>				
11.	Have clear guidelines for ethical behavior been communicated to all employees? If yes, how have employees been recognized when their actions support the ethical goals of the business? If no, is a code of conduct that reflects the ethics of the business being formulated?			
12.	Does the business return value to the community by supporting socially responsible programs? If yes, how have these efforts been communicated to employees and other interested parties? If no, what programs are under consideration for support?			

## MARKETING PERFORMANCE

		Yes	No	Action Required
<b>MARKETING ORIENTATION</b>				
1.	Is marketing research directed at determining customer needs conducted on a regular basis? If yes, have customer responses been incorporated into business activities and/or plans? If no, have plans been made to conduct basic marketing research?			
2.	Are employees who do not interact with customers aware of how their jobs might influence customer satisfaction? If yes, are efforts being made to improve customer satisfaction? If no, what type of training are they scheduled to receive?			
<b>ATTRACTING NEW CUSTOMERS</b>				
3.	Are formal strategies in place to attract new customers? If yes, has the cost effectiveness of each strategy been assessed? If no, what steps are being taken to identify approaches for attracting new customers?			
4.	Are employees motivated to sell to prospective customers? If yes, are programs in place to recognize and/or reward these employees? If no, are steps being taken to educate employees as to the value of prospective customers to the future success of the business?			
5.	Is the organization capable of delivering on the promises made to attract new customers? If yes, are customers being surveyed to determine their level of satisfaction? If no, are steps being taken to ensure service quality?			
<b>SERVING CUSTOMERS</b>				
6.	Are employees properly trained to perform their service roles? If yes, are programs in place to recognize and/or reward these employees? If no, have plans been made to train employees properly?			

7.	Are customers offered concrete reasons for doing more business with the company? If yes, how have these reasons been communicated to customers? If no, have steps been taken to identify the reasons customers patronize the business?			
8.	Are customers made aware that their patronage is valued? If yes, how is this recognition communicated to customers? If no, how can customers be informed that they are important to the success of the business?			
9.	Is sufficient attention paid to solving customer problems when they occur? If yes, are records of customer complaints being maintained so that potential problems in the system can be solved? If no, have plans been made to train employees in customer service recovery procedures?			
10.	Do the facilities and communication materials of the organization appear attractive to customers? If yes, have time tables been established to review and update current facilities and offerings? If no, have plans been made to address deficiencies?			
11.	Does the organization offer tangible evidence of the quality of its services? If yes, how is quality communicated to customers? If no, what steps are being taken to identify ways of providing tangible evidence of quality?			
12.	Do the products/services offered by the organization meet the needs of the customer? If yes, how are these perceptions documented? If no, are steps being taken to identify customer wants and needs?			

## FINANCIAL PERFORMANCE

		Yes	No	Action Required
<b>BUDGETING</b>				
1.	Is a sales budget prepared for each month of the coming year? If yes, is this budget updated monthly to reflect changes in the business environment? If no, what plans are being made to develop this budget?			
2.	Is an expense and purchases budget prepared for each month of the coming year? If yes, is this budget updated monthly to reflect significant changes? If no, what plans are being made to develop this budget?			
3.	Is a capital expenditures budget prepared for each month of the coming year? If yes, have these expenditures been made to retain a competitive advantage? If no, what plans are being made to develop this budget?			
4.	Is a budget of projected cash flows prepared for each month of the coming year? If yes, is it being updated on a monthly basis to reflect changes in levels of business activity? If no, what plans are being made to develop and maintain this budget?			
5.	Have performance benchmarks been established for all quantifiable performance measures? If yes, have actual results been compared to budgeted amounts? If no, have competitors or industry sources been identified where these performance benchmark measures can be obtained?			

<b>RATIO ANALYSIS</b>				
6.	Has the return on investment been calculated for the most recent accounting period? If yes, has this information been analyzed to determine ways of improving profitability? If no, have plans been made to analyze return on investment?			
7.	Has the current ratio been calculated for the most recent accounting period? If yes, do measures need to be taken to improve the current financial position of the business? If no, have plans been made to analyze the current ratio?			
8.	Has the accounts receivable turnover ratio been calculated for the most recent accounting period? If yes, has the average days in receivables ratio been calculated? If no, have plans been made to analyze the accounts receivable turnover ratio?			
9.	Has the inventory turnover ratio been calculated for the most recent accounting period? If yes, has the average days in inventory ratio been calculated? If no, have plans been made to analyze the inventory turnover ratio?			
10.	Have these ratios been compared to those of past accounting periods, industry standards and/or projected ratios? If yes, is yes do the results meet with your performance targets? If no, what sources for obtaining comparable ratios have been identified?			
<b>INFLATION ADJUSTMENTS</b>				
11.	Has a source been identified for obtaining inflation information that is appropriate for your geographic region? If yes, is this source reviewed on a regular basis? If no, what measures are being taken to locate an appropriate source of information?			
12.	Have the sales, cost of goods sold, net income and other relevant figures been adjusted to determine the effects of inflation? If yes, have financial performance measures been improving? If no, what measures are being taken to determine the effects of inflation?			

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## APPENDIX 2

### GUIDELINES FOR RATIO ANALYSIS

Ratio analysis plays an important role in evaluating the financial performance of a business. Four ratios have been selected for analysis in the scorecard. A brief discussion of each follows.

#### Return on Investment

Return on investment (ROI) is a measure of a business' earnings in relation to its investment in assets--margin and turnover.

$$\text{MARGIN} \quad \times \quad \text{TURNOVER} \quad = \quad \text{EARNING POWER}$$

$$\frac{\text{Net Operating Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Average Operating Assets}} = \frac{\text{Net Operating Income}}{\text{Average Operating Asset}}$$

(1)

Margin measures the amount of each sales dollar remaining after the operating expenses have been deducted. The lower the operating expenses, the higher net operating income and margin will be. Turnover is a measure of the number of times each dollar of operating assets has been used to produce a dollar of sales. Turnover measures a business' control over investments in operating assets. The lower the investment in operating assets, the higher the turnover will be.

Using this information, the return on investment or earning power of the business can be improved in three ways. ROI can be increased by:

- increasing sales at a faster rate than the corresponding expenses increase,
- decreasing expenses more than sales decrease, or
- decreasing the operating assets used without changing the sales or operating expenses.

#### Current Ratio

The current ratio is a measure of whether or not the cash flows from current assets will be sufficient to meet the current liabilities of the business. A comparison of the current assets to the current liabilities shows how many dollars of current assets are available to cover each dollar of current liabilities. Although a relatively high current ratio is often desired, caution should be exercised when analyzing this ratio since a very high number may suggest that too much inventory is on hand, or that the accounts receivable are not turning over quickly enough. There are several ways to improve the current ratio:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

(2)

- sell fixed assets and use the cash to increase current assets or pay off current liabilities,
- use long-term borrowing to purchase assets or pay off current liabilities, and
- use current assets to pay off current liabilities.

### Accounts Receivable Turnover

$$\text{The accounts receivable turnover} = \frac{\text{Annual Credit Sales}}{\text{Average Trade Accounts Receivable}} \quad (3)$$

shows how often the receivables are collected during an accounting period. For example, if the turnover is six times per year, the average waiting time for the collection of a receivable is two months; if it is four times per year, the average collection period is three months. A receivable turnover that is too high may result in money being tied up in receivables that could be put to use in purchasing more inventory. If the receivable turnover is too low, it could indicate a credit policy that is too tight.

$$\text{A related performance measure that can be evaluated is} = \frac{360 \text{ Days}}{\text{Accounts Receivable Turnover}} \quad (4)$$

the average collection period on accounts receivable. This performance standard will indicate the average length of time it takes to collect an account receivable. As the days required to collect receivables increases, the owner's need for capital also increases.

### Inventory Turnover

$$\text{Inventory turnover also shows how efficiently the capital invested in inventory is being} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} \quad (5)$$

utilized and indicates how quickly it is being converted into sales. A low inventory turnover may indicate that excessive stock, obsolete stock and/or slow moving stock is on hand. A high turnover may result in a loss of customers due to stockouts on popular items. However, keep in mind that there is always a trade-off between overstocking and the possibility of running out of an item occasionally.

$$\text{Another related measure, days inventory on hand, indicates the average length of time inventory} = \frac{360 \text{ Days}}{\text{Inventory Turnover}} \quad (6)$$

is being kept in the business. Since items kept in inventory have a tendency to lose value if retained too long, careful attention should be directed toward managing these assets.

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## APPENDIX 3

### GUIDELINES FOR INFLATION ADJUSTED TREND ANALYSIS

The typical yardstick used to adjust for general inflation is the Consumer Price Index (CPI), although other indices may be used. Current information on the CPI can be obtained from the Monthly Labor Review which can be found in most libraries. Any base year may be selected to review a particular time frame. It is advisable to review and adjust financial data to reflect the impact of inflation over at least a three-year period, although a five-year period is preferable. An adjustment factor can be obtained by dividing the CPI for each of the successive years by the reported CPI for a selected base year. For example, if a five-year period is selected using 1988 as the base year, the following information on the CPI would be used.

<u>Year</u>	<u>CPI</u>	<u>Adjustment Factor</u>
1988	354.3	1.00
1989	371.3	1.05
1990	391.4	1.10
1991	408.8	1.15
1992	420.3	1.19
1993	432.7	1.22

Once the adjustment factor has been calculated, it can then be divided into reported data to obtain a more realistic financial picture. For example, reported sales figures of a firm may have shown steady growth each year from a base of \$100,000 in 1988 to \$122,000 in 1993. It may appear as if the firm has grown, but, in reality, it has had stagnant sales when inflation is taken into account ( $\$122,000 / 1.22 = \$100,000$ ). If a more detailed analysis of the effects of inflation on the finances of a firm is desired, this same process can be followed on any of the firm's reported financial data.