



CAPACITY BUILDING SOLUTIONS • INSIGHTS

Know Your Numbers

Building Financial Literacy in Yourself and Your
Leadership Team

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I was facilitating a CEO group not long ago when one of the members said something I have heard, in one form or another, hundreds of times. We were talking about a decision he was wrestling with, and I asked him what his gross margin had done over the past three years. He paused, then said, "I'd have to ask my accountant. That's what I pay her for."

I understand the instinct. You build a company around a product, a service, or a relationship you understand deeply. Very few owners start out fluent in financial statements, and hiring good people to keep the books is exactly the right move. But there is a difference between delegating the bookkeeping and delegating the understanding. When you hand off the understanding, you are no longer leading the business with your eyes open. You are trusting that someone else will notice the things you cannot see.

I say this often to the leaders I work with, and I will say it here: conscious ignorance of the financial matters that affect your business is not a legitimate leadership excuse. You do not need to become an accountant. You do need to be able to read your own numbers well enough to see trouble early, recognize opportunity clearly, and ask sharper questions of the people who prepare them. That skill is entirely learnable, and it is one of the highest-return investments you can make in yourself.

There is a second half to this that owners tend to overlook. Financial literacy shouldn't stop with you. When your leadership team understands how their decisions affect margins, cash, and value, they make better choices without waiting for you to weigh in. Strategy and finance finally start pulling in the same direction. A financially fluent CEO is powerful. A financially fluent leadership team is a different kind of company.

The reassuring part is that the math involved is not hard — most of the numbers that matter are a single division you could do on a napkin. To keep this grounded, I will lean on one example business throughout: a company doing about \$5 million in revenue, with the kind of profile many owners will recognize. Rather than open with a wall of numbers, I will pull its figures in as we go and keep the full snapshot — along with every formula, the arithmetic behind it, and a plain-language glossary of every term — in a reference at the end. That way the ideas can breathe here, and the calculations are right there when you want to run your own.

With that, financial literacy comes down to getting good at three things: honestly gauging the health of the business, tracking the handful of numbers that actually matter, and making sound decisions about where to put your money. Let's take them one at a time.



Gauging Your Financial Health and the Red Flags Worth Watching

Start with a distinction that trips up more owners than any other: profit and cash are not the same thing. Profit is an accounting opinion about a period of time. Cash is a fact you can count in the bank. A business can look profitable on paper and still run out of money, because a sale you booked in March may not be collected until May, and the inventory or payroll it took to earn that sale went out the door weeks ago. So when you judge the health of your business, look at both, and never assume a good profit number means the cash is there.

The three financial statements each answer a different question, and you need all three. The income statement tells you whether you made money over a period. The balance sheet is a snapshot of what you own and what you owe at a moment in time — and it always balances, because what you own equals what you owe plus what is left over for the owners. The cash flow statement, the one owners most often ignore and often the most important, shows where your cash actually came from and where it went. You don't have to prepare these. You do have to be able to read them.

Once you can read them, the real skill is reading them over time, because most trouble shows up first as a trend, not as a single bad number. In my experience, a handful of red flags account for most of the financial trouble small and mid-sized businesses get into, and every one of them is visible early if you are looking.

The first is a gross margin that is quietly slipping. Gross margin is simply the share of each sales dollar left after the direct cost of producing what you sell — in our example company, about 42 cents on the dollar. The figure itself matters less than its direction. If it was 46 cents two years ago and 42 today, something is eroding, usually costs rising faster than your prices or discounting that has quietly become a habit, and it rarely reverses on its own. And if you sell services rather than products, do not assume this doesn't apply to you. It does. Your "cost of goods" is the cost of delivering the work — the billable labor, the subcontractors, the direct costs of a specific engagement — but not your rent, your administrative salaries, or your marketing. A firm billing a million dollars a year that spends six hundred thousand actually delivering the work is keeping 40 cents on the dollar to cover overhead and profit. Plenty of service owners never calculate this, because they assume they have no cost of goods at all — and they are missing one of the most important numbers they have.

Close behind is collections that are slowing down. If your customers used to pay in thirty days and now take closer to fifty, cash is draining out of the business even while sales look fine. Our example company is waiting about forty-seven days to get paid on thirty-day terms — roughly two and a half weeks of sales sitting in someone else's bank account instead of its own. Watch the direction of that number as closely as the number itself.

The rest of the red flags are really about fragility. One is having too much revenue riding on too few customers: once a single account climbs much above 15 percent of your revenue, or your top five pass a third of it, you are one lost relationship away from a serious problem — our example's largest customer, at 18 percent, is worth working down. Another is a cash cushion too thin to absorb a shock. Most businesses should keep three to six months of operating expenses in reserve. I like to look at it two ways. The first is simply how many days of cash you have on hand. The second is what I call operating-expense coverage: take your cash, add the money your customers are about to pay you, subtract what you owe your suppliers, and divide the result by a single month of operating costs. I want to see at least three and a half months there. A company with barely a month of either is exposed no matter how good this month looked. A third red flag is debt creeping up on you — leaning on the credit line month after month, watching your debt climb much past about 1.4 times your equity, or watching your coverage of loan payments grow thin. On that point, here is one I feel strongly about: never use debt to pay yourself a salary the business cannot actually afford. And the last one surprises people, because it doesn't feel like a problem at all: growth outrunning cash. Our example grew a healthy 11 percent, but growth consumes cash — more inventory, more payroll, more receivables — before it produces profit, and growing fast without the cash to fund it is how good companies get squeezed into a crisis.

There is one more number I keep on every dashboard, because it pulls several of these threads into a single early warning: a private-company version of the Altman Z-Score. It blends your liquidity, your accumulated earnings, your operating return, and how much equity cushions your debt into one figure. Above about 2.6, the business is on solid ground; a slide toward 1.1 is a genuine danger signal. It won't tell you exactly what is wrong, but it will tell you to go look — which is precisely what a good early-warning number is for.

The point of watching for these is not to live in fear of the numbers. It is to catch a problem while it is still small and cheap to fix. That is the whole reason to build the habit of looking.



The health checks, by the numbers:

Measure	Formula	Worked example
Gross margin (product)	$(\text{Revenue} - \text{Cost of Goods Sold}) \div \text{Revenue}$	$(\$5,000,000 - \$2,900,000) \div \$5,000,000 = \mathbf{42\%}$
Gross profit (service)	$\text{Revenue} - \text{Cost of delivering the service}$	$\$1,000,000 - \$600,000 = \mathbf{\$400,000 (40\%)}$
Days Sales Outstanding	$(\text{Accounts Receivable} \div \text{Revenue}) \times 365$	$(\$650,000 \div \$5,000,000) \times 365 = \mathbf{47 \text{ days}}$
Customer concentration	$\text{Largest customer} \div \text{Total revenue}$	$\$900,000 \div \$5,000,000 = \mathbf{18\%}$
Months of cash reserve	$\text{Cash} \div \text{Average monthly operating costs (all-in)}$	$\$300,000 \div \sim \$358,000 = \mathbf{\text{under 1 month}}$ (target 3–6)
Debt Service Coverage Ratio	$\text{EBITDA} \div \text{Annual debt service}$	$\$880,000 \div \$320,000 = \mathbf{2.75}$ (lenders worry below ~1.25)
Revenue growth	$(\text{This year} \div \text{Last year}) - 1$	$(\$5,000,000 \div \$4,500,000) - 1 = \mathbf{11\%}$

EBITDA, in the coverage row above, is your earnings before interest, taxes, and the non-cash charges for depreciation and amortization — a rough stand-in for the cash your operations produce. Every other abbreviation is spelled out in the glossary at the end.



The Numbers That Matter: Leading and Lagging Indicators

Owners often ask me which numbers they should track. My answer is usually another question: track them for what? A number you look at but never act on is just noise. The goal is not a longer dashboard. It is a shorter one, made up of the numbers that actually change what you do.

Here is a distinction I find genuinely useful, and one worth teaching your whole team: the difference between lagging and leading indicators.

Lagging indicators tell you what already happened — revenue, profit, margins, the return you are earning on the money invested in the business. They are the scoreboard, and they matter enormously, but they are a rear-view mirror. Our example company keeps a little under nine cents of profit on every dollar of sales and earns a healthy return on its owners' equity, and both are worth knowing. But by the time a disappointing profit shows up in last month's statement, the decisions that caused it were made weeks ago. You cannot change a lagging number directly. You can only change the things that feed it.

Leading indicators are those things that feed it, and they give you room to act before the result is locked in. These are the ones I most want to see on the dashboards I build with the CEOs I work with. How much qualified opportunity sits in your pipeline. For businesses that carry a backlog — work you have already booked but not yet delivered — how much of that is waiting to be done. Set pipeline and backlog against your revenue over the last twelve months, and you can see how much of next year is already spoken for.



How often you win the proposals you submit. How many days of cash you actually have on hand. And whether the gap between how long you take to collect and how long you take to pay is moving for you or against you. These all move before the financial results do, which is exactly why they are worth watching — a thin pipeline or a slipping win rate is a revenue problem you can still fix, while last quarter's revenue is simply a fact. Most owners track the lagging numbers almost exclusively, because those are the ones the accounting system hands them. The leaders who consistently outperform watch the leading ones too, because those are the ones they can still do something about.

You don't need dozens of these. You need the ten or twelve that matter most for your business, reviewed on a rhythm that fits how fast they move — cash and sales weekly, margins and collections monthly, the bigger structural measures each quarter. What matters is not the exact schedule. It is that you review them consistently and respond to what they tell you.

A number on its own, though, doesn't tell you much. It needs something to be measured against. The best yardstick, whenever you can get it, is data from your own industry, because the same figure can mean very different things in different businesses — a 42 percent gross margin or a 47-day collection cycle reads one way for a contractor and another entirely for a professional services firm, and only industry data tells you which. When you can't get good industry numbers, the next best comparison is your own history: are you better or worse than you were a year ago, and which way is the trend pointing? On the dashboards I build, every number is shown a few ways at once: against its target, against the same period a year ago, and — where I have the data — against peers in the same industry and size band, including the best in class. And I show it all on a rolling twelve-month basis — the last twelve months, not just one — which smooths out the noise of any single month so you can see the real direction. There are generic, all-industry benchmarks out there too, and they have their place as a rough sanity check, but apply them with care — what looks "healthy" in the abstract can be misleading for your particular business. The point of comparing isn't to hit someone else's number. It's to understand where you stand and where you are heading.

This is also where bringing your team along pays off. Put the dozen numbers that matter on a single page, each with a trend arrow beside it, and walk your leadership team through them on a regular cadence. Explain what each one means and why it moves. You are not just reporting results; you are teaching your people to think the way you are learning to think. A leadership team that cannot see the score cannot help you win the game.

A few of each, by the numbers:

Type	Measure	Formula	Worked example
Lagging	Net profit margin	Net profit ÷ Revenue	$\$430,000 \div \$5,000,000 = 8.6\%$
Lagging	Return on equity	Net profit ÷ Owner's equity	$\$430,000 \div \$1,600,000 = 26.9\%$
Lagging	Current ratio	Current assets ÷ Current liabilities	$\$1,400,000 \div \$800,000 = 1.75$ (target ≥ 1.5)
Leading	Pipeline + backlog vs. revenue	(Pipeline + Backlog) ÷ TTM revenue	$(\$600,000 + \$900,000) \div \$5,000,000 = 30\%$
Leading	Win rate	Deals won ÷ Proposals submitted	$6 \div 20 = 30\%$
Leading	Days cash on hand	Cash ÷ (Annual operating costs ÷ 365)	$\$300,000 \div \$11,781 = \sim 26 \text{ days}$
Leading	Cash-conversion gap	Days in A/R – Days in A/P	$47 - 44 = 3 \text{ days}$



Making Good Investment Decisions

Sooner or later, financial literacy stops being about reading the past and starts being about deciding the future. Should you buy the equipment? Hire ahead of the growth? Open the second location? Take on the debt to do it? This is where the numbers earn their keep, and where clear thinking separates the owners who compound their advantages from the ones who lurch from one expensive guess to the next.

The single most useful discipline I know for these decisions is to compare what you expect an investment to return against what the money costs you. Borrow at 6 percent to fund something you can reasonably expect to return 8, and you have a two-point spread working in your favor and an investment that is creating value. Reverse those numbers and you are destroying value even if the project feels exciting. The discipline is in being honest about the expected return, because an optimistic assumption can make almost any bad idea look good.

Two simple tools sharpen the picture. The first is payback period — how long until the investment returns the cash it consumed. A \$150,000 machine that generates \$60,000 of added cash a year pays for itself in about two and a half years, and the shorter that stretch, the less time you are exposed if you turn out to be wrong. The second is return on investment, which puts the same thing in percentage terms so you can hold it against your cost of capital. That machine's \$60,000 return on a \$150,000 outlay is roughly a 40 percent annual return — comfortably above a 6 percent borrowing cost, and a strong positive spread. For larger, longer-lived investments, remember that a dollar you receive three years from now is worth less than a dollar today, so the further out the payoff, the more conservative your assumptions should be.

The numbers, though, only tell you whether an investment pencils out. They cannot tell you whether it is the right investment. For that, I keep coming back to a question worth asking before you write any check: what problem are you really trying to solve? A surprising number of investments are answers to the wrong question. The new system, the new hire, the new location — sometimes they are exactly right, and sometimes they are an expensive way of avoiding a harder conversation about pricing, focus, or a customer relationship that isn't working.

Two more questions belong in every one of these decisions. What happens to my cash — not just my profit — while this plays out? And what could go wrong, and could I survive it if it did? Good decisions account for the downside, not just the upside. And when you are already committed to something that isn't working, the same honesty applies in reverse: is this still the right investment, or am I holding on simply because I have already spent the money? Knowing when to stop is as much a part of good financial judgment as knowing when to start.

The investment tests, by the numbers:

Measure	Formula	Worked example
Spread	Expected return % – Cost of capital %	$8\% - 6\% = 2$ points in your favor
Payback period	Initial investment ÷ Annual cash it generates	$\$150,000 \div \$60,000 = 2.5$ years
Return on investment	Annual return ÷ Amount invested	$\$60,000 \div \$150,000 = 40\%$ per year

Where to Begin

None of this requires you to become a financial expert. It requires you to lead your business with your eyes open, and to bring your team into that same clarity. The formulas below are not complicated — most are a single division you could run in your head. What makes them powerful is using them consistently, watching the trend, and acting on what they tell you.

If you are not sure where to start, start small. Pick a few numbers that matter most for your business. Learn to read them, look at them on a regular rhythm, and compare them to where you were a year ago and to others in your industry. Then sit down with your leadership team and walk through the statements together, not as a lecture but as a shared way of thinking. Ask the questions that make people look up from the spreadsheet:

- ◆ What are our numbers telling us that we didn't already know?
- ◆ Which red flag would we least want to admit is already there?
- ◆ Which of our leading indicators would warn us first if things were turning?
- ◆ What problem are we really trying to solve with our next big investment?

The businesses that endure are led by people who know their numbers — and who have surrounded themselves with a team that knows them too. That knowledge is entirely learnable. The only real question is whether you decide it is worth learning. In my experience, the owners who do are rarely the ones caught by surprise.

Reference:

The Numbers Behind This Article

Every figure in the article comes from one example business. Here is its full picture, followed by each formula and the arithmetic behind it, so you can run the same numbers for your own company. Any target ranges shown below are general rules of thumb — your own industry's data is a better guide, and your own history is a good one; use the generic figures with care.

A Quick Plain-Language Glossary

Every shorthand term used in this article, in plain English:

- ◆ **EBIT** (earnings before interest and taxes) — your operating profit, before financing costs and taxes.
- ◆ **EBITDA** — EBIT plus the non-cash charges for depreciation and amortization; a rough stand-in for the cash your operations generate.
- ◆ **COGS** (cost of goods sold) — the direct cost of producing what you sell; for a service business, the cost of delivering the work.
- ◆ **A/R** (accounts receivable) — money your customers owe you.
- ◆ **A/P** (accounts payable) — money you owe your suppliers.
- ◆ **DSO** (days sales outstanding) — the average number of days it takes to collect after you send an invoice.
- ◆ **DPO** (days payable outstanding) — the average number of days you take to pay your suppliers.
- ◆ **DSCR** (debt service coverage ratio) — operating earnings divided by your loan payments; how comfortably you cover the debt.
- ◆ **ROA / ROE / ROI** — return on assets / return on equity / return on investment.
- ◆ **ROCE** (return on capital employed) — operating profit as a percentage of the capital the business actually uses (total assets minus short-term liabilities).

- ◆ **Working capital** – current assets minus current liabilities; your short-term cushion.
- ◆ **TTM** (trailing twelve months) – the most recent twelve months, updated each month, rather than a calendar year.
- ◆ **WIP** (work in progress) – work you have started or booked but not yet finished or billed.
- ◆ **Backlog** – booked orders or contracts you have not yet delivered.
- ◆ **Factored pipeline** – potential sales weighted by the odds each deal actually closes (a \$100,000 deal with a 50% chance of closing counts as \$50,000).
- ◆ **FTE** (full-time equivalent) – one full-time employee's worth of hours; two half-time people equal one FTE.
- ◆ **Z-Score** – a single score that combines several ratios into one early-warning signal for financial distress.

The investment tests, by the numbers:

Item	Amount
Revenue (this year)	\$5,000,000
Revenue (prior year)	\$4,500,000
Cost of goods sold	\$2,900,000
Gross profit	\$2,100,000
Operating income (EBIT)	\$700,000
Depreciation & amortization	\$180,000
EBITDA	\$880,000
Net profit	\$430,000
Cash on hand	\$300,000

Item	Amount
Accounts receivable	\$650,000
Current assets / current liabilities	\$1,400,000 / \$800,000
Total assets / total liabilities	\$3,200,000 / \$1,600,000
Owner's equity / retained earnings	\$1,600,000 / \$1,200,000
Accounts receivable / accounts payable	\$650,000 / \$350,000
Total debt / annual debt service	\$1,000,000 / \$320,000
Annual operating costs (all-in)	\$4,300,000
Full-time employees (FTEs)	30
Qualified pipeline (factored) / backlog (WIP)	\$600,000 / \$900,000
Largest customer	\$900,000

Gauging Financial Health

Measure	Formula	Worked example
Gross margin (product)	$(\text{Revenue} - \text{Cost of Goods Sold}) \div \text{Revenue}$	$(\$5,000,000 - \$2,900,000) \div \$5,000,000 = \mathbf{42\%}$
Gross profit (service)	$\text{Revenue} - \text{Cost of delivering the service}$	$\$1,000,000 - \$600,000 = \mathbf{\$400,000 (40\%)}$
Days Sales Outstanding	$(\text{Accounts Receivable} \div \text{Revenue}) \times 365$	$(\$650,000 \div \$5,000,000) \times 365 = \mathbf{47 \text{ days}}$
Customer concentration	$\text{Largest customer} \div \text{Total revenue}$	$\$900,000 \div \$5,000,000 = \mathbf{18\%}$

Measure	Formula	Worked example
Months of cash reserve	Cash ÷ Average monthly operating costs (all-in)	$\$300,000 \div \sim \$358,000 = \text{under } 1 \text{ month}$ (target 3–6)
Debt Service Coverage Ratio	EBITDA ÷ Annual debt service	$\$880,000 \div \$320,000 = 2.75$ (lenders worry below ~1.25)
Revenue growth	(This year ÷ Last year) – 1	$(\$5,000,000 \div \$4,500,000) - 1 = 11\%$
Debt-to-Equity	Total liabilities ÷ Owner's equity	$\$1,600,000 \div \$1,600,000 = 1.0$ (target ≤ 1.4)
Operating-expense coverage	(Cash + A/R – A/P) ÷ Monthly operating costs	$(\$300,000 + \$650,000 - \$350,000) \div \$358,000 = 1.7 \text{ months}$ (target ≥ 3.5)
Days cash on hand	Cash ÷ (Annual operating costs ÷ 365)	$\$300,000 \div \$11,781 = \sim 26 \text{ days}$
Balance-sheet identity	Assets = Liabilities + Equity	always balances

EBITDA is earnings before interest, taxes, depreciation, and amortization — a rough proxy for the cash your operations generate.

KPIs — Lagging and Leading

Type	Measure	Formula	Worked example
Lagging	Net profit margin	Net profit ÷ Revenue	$\$430,000 \div \$5,000,000 = 8.6\%$
Lagging	Return on equity	Net profit ÷ Owner's equity	$\$430,000 \div \$1,600,000 = 26.9\%$
Lagging	Current ratio	Current assets ÷ Current liabilities	$\$1,400,000 \div \$800,000 = 1.75$ (target ≥ 1.5)

Type	Measure	Formula	Worked example
Leading	Pipeline + backlog vs. revenue	$(\text{Pipeline} + \text{Backlog}) \div \text{TTM revenue}$	$\$430,000 \div \$5,000,000 = \mathbf{8.6\%}$
Lagging	Return on equity	$\text{Net profit} \div \text{Owner's equity}$	$\$430,000 \div \$1,600,000 = \mathbf{26.9\%}$
Lagging	Current ratio	$\text{Current assets} \div \text{Current liabilities}$	$(\$600,000 + \$900,000) \div \$5,000,000 = \mathbf{30\%}$
Leading	Win rate	$\text{Deals won} \div \text{Proposals submitted}$	$6 \div 20 = \mathbf{30\%}$
Leading	Days cash on hand	$\text{Cash} \div (\text{Annual operating costs} \div 365)$	$\$300,000 \div \$11,781 = \mathbf{\sim 26 \text{ days}}$
Lagging	Return on assets (ROA)	$\text{Net profit} \div \text{Total assets}$	$\$430,000 \div \$3,200,000 = \mathbf{13.4\%}$
Lagging	Return on capital employed	$\text{EBIT} \div (\text{Total assets} - \text{Current liabilities})$	$\$700,000 \div \$2,400,000 = \mathbf{29.2\%}$
Lagging	Rule of 40 (Ed's version)	$\text{Revenue growth \%} + \text{operating-profit (EBIT) margin \%}$	$11\% + 14\% = \mathbf{25}$ (target ≥ 40)
Lagging	Revenue per employee	$\text{Revenue} \div \text{Full-time employees}$	$\$5,000,000 \div 30 = \mathbf{\sim \$166,700}$
Leading	Cash-conversion gap	$\text{Days in A/R} - \text{Days in A/P}$	$47 - 44 = \mathbf{3 \text{ days}}$

Revenue per employee pairs with total cost per employee; when revenue per head runs well above cost per head ("employee leverage"), your team is generating profit, not just activity.

Making Investment Decisions

Measure	Formula	Worked example
Spread	Expected return % – Cost of capital %	8% – 6% = 2 points in your favor
Payback period	Initial investment ÷ Annual cash it generates	\$150,000 ÷ \$60,000 = 2.5 years
Return on investment	Annual return ÷ Amount invested	\$60,000 ÷ \$150,000 = 40% per year

The Early-Warning Composite: A Private-Company Z-Score

This is the single early-warning number referenced in the article. It uses the Altman "Z-double-prime" model built for private, non-manufacturing businesses, which blends four ratios into one score:

$$Z = 6.56 \cdot (A) + 3.26 \cdot (B) + 6.72 \cdot (C) + 1.05 \cdot (D)$$

Component	What it captures	Example company
A = Working Capital ÷ Total Assets	Short-term liquidity	$(\$1,400,000 - \$800,000) \div \$3,200,000 = 0.19 \rightarrow \mathbf{1.23}$
B = Retained Earnings ÷ Total Assets	Accumulated profitability	$\$1,200,000 \div \$3,200,000 = 0.375 \rightarrow \mathbf{1.22}$
C = EBIT ÷ Total Assets	Operating return on assets	$\$700,000 \div \$3,200,000 = 0.22 \rightarrow \mathbf{1.47}$
D = Equity ÷ Total Liabilities	Solvency cushion	$\$1,600,000 \div \$1,600,000 = 1.0 \rightarrow \mathbf{1.05}$
Z-Score (sum)		≈ 4.97

Zones: above 2.60 — on solid ground; **1.10–2.60** — survival questionable, investigate; below **1.10** — failure risk imminent. (Named for Edward Altman, who introduced the original model in 1968.)

How the Dashboard Frames Every Number

No single figure is read in isolation. Each is shown against four things at once: its **target**, the **prior year**, the **budget**, and, where the data exists, **peers** in the same industry and size band (including the best in class) — and on a **trailing-twelve-month (TTM)** basis, so a single strong or weak month doesn't distort the trend.

Ed Robinson is a Vistage Chair and the founder of Capacity Building Solutions, where he helps owners and CEOs sharpen their leadership and the quality of their decisions. Learn more at www.capacity-building.com.

