Key Ratios Defined

By tracking certain ratios, you can monitor the performance of your business, which can help you keep your employees and financial backers informed.

Cash Related Ratios

Monitoring cash is essential to every business. The" burn rate" is a good tool; you measure how fast you are consuming cash compared to the cash you are generating. A lack of cash can mean the end for your company. Always keep an eye on your cash flow if you want to stay in the game.

Sales Ratios

The volume of transactions and the average value of each transaction are critical for many businesses and should be monitored daily. Whenever possible, it is important to monitor your market share and the proportion of repeat business you are getting (i.e. customers coming back).

Profitability Ratios

The most common ratios to measure profitability include the following:

- The gross margin: measures the ability of the business to sell at a premium compared to its direct costs.
- The EBITDA (earnings before interest, tax, depreciation and amortisation): measures your company's ability to make money before considering the amount of funds invested into the business.

Financial Literacy

This document aims to present the key ratios you should monitor carefully to manage your business.

Gross margin

The most common ratio to measure profitability is the gross margin which measures the ability of the business to sell at a premium compared to its direct costs. An insufficient gross margin will not allow the business to pay for its fixed costs. A declining one means that the clients are not willing to pay the desired price or the COGS are increasing faster than the company can raise its prices.

The gross margin can be calculated in two ways:

1. **Gross profit / Revenue**
2. **(Revenue - cost of goods sold) / Revenue**

EBITDA

Another common measurement is the EBITDA, earnings before interest taxes depreciation and amortization. This profitability level shows the ability of a business to make money without considering the amount of funds invested in the business; it is a useful number to compare your profitability with the one from your direct competitors.

Formula: EBIT + Depreciation + Amortization

Average receivable (Accounts Receivable Turnover)

The average receivable measures in number of days how long it takes for your customers to pay and you can compare it with the average payable which is how fast you are paying your suppliers. Inventory ratio will allow you to track the sell through of the products you have purchased. The average receivable is normally calculated annually but it is wise to calculate it on a monthly basis to examine crediting trends.

Formula: Net Credit Sales / Average Accounts Receivable

Operating Expense

Operating expenses are expenses other than your costs of goods sold, direct expenses, other income or other expenses. They are considered the continuous financial obligations incurred in the daily operation of the business. Your operating expense control can make a huge difference in your gross profit margin.

Formula: Total Operating Expenses / Revenues

Return on Assets

Assets are your firm's total assets, not just what the company owns. Return on assets is calculated by dividing net operating income after tax (but before other income or expenses like interest expense) by total assets.

Formula: Annual Net Income / Average Total Assets

Working Capital

Every business has a working capital. It measures the cash or liquid assets that are needed for the day-to-day operations of the business. The working capital ratio allows you to see if you can meet your financial obligations.

Formula: Current Assets / Current Liabilities

Debt-to-Worth (Debt-to-Equity)

This ratio measures the financial risk of a company. It measures the amount of debt a company as compared to the net worth. It gives an indication if a business is likely to make a profit.

Formula: (Accounts Payable + Long Term Debt + Other Loans) / Total Net Worth

Days Payable Outsanding (DPO)

This shows the amount of time in days a business has to pay back creditors. It also shows the number of days the company can use the cash before having to pay back the creditors. The longer the time frame is, the better.

Formula: (Accounts Payable/Cost of Goods Sold) x 365

Operating Cash flow / Sales Ratio

This ratio allows a company to measure a company's ability to convert sales into cash. The higher the number the better and may indicate that a company is in a good position to grow.

Formula: (Operating Cash flow x 100) / Sales

Free Cash flow (FCF)

This ratio indicates the amount of remaining cash after payment is made for capital expenditures. It as an essential ratio as it shows the competitiveness and efficiency of a company.

Formula: Operating Cash Flow - Capital Expenditures

Cost analysis

This document will help you understand the differences between fixed and variable costs and highlight the importance of managing them differently. Even if these costs are naturally different their common aspect is that they can be both expressed as, onetime expenses or repeated ones.

Fixed costs

Fixed cost is one which does not vary in total when the level of output by the business does vary. In other words, when the Sales' level within a business increases, fixed costs in total would not increase. It also follows the same pattern when the Sales level in a business decreases, the fixed costs would not decrease.

Example of fixed costs

- Rent,
- Utilities,
- Some taxes and fees,
- Salaries,
- Employee's benefits.

Variable costs

Variable costs are linked to the volume of transactions. The costs of goods sold (COGS) which include the allocated costs to pay for goods and services like transportation or custom duties. In other words, as sales increase the variable costs increase.

Example of fixed costs

- Raw Material,
- Machinery,
- Commissions,
- Credit Cards fees.