



Top financial indicators every entrepreneur should know

Use the financial data you have at hand to carefully grow your business



What are you going to find here?

The importance of financial ratios	2
Liquidity ratios	4
Current ratio	5
Quick ratio	7
Cash ratio	8
Profitability ratios	9
Gross profit margin	10
Operating profit margin	11
Net profit margin	12
Return on Assets	13
Return on Equity	14
Efficiency ratios	15
Inventory turnover	16
Days in Inventory (DII)	17
Days Sales Outstanding (DSO)	18
Days Payable Outstanding (DPO)	19
Property, plant and equipment turnover (PPE turnover)	20
Asset turnover ratio	21
Cash Conversion Cycle (CCC)	22
Leverage ratios	23
Debt ratio	24
Debt to equity ratio (D/E)	25
Interest coverage ratio	26
Solvency ratio	27

The importance of financial ratios

The ability to understand the data from your company's financial documents is crucial, but unfortunately it doesn't offer you a complete overview of your business. Of course the balance sheet, P&L, and cash flow statement are important for your daily operations, but this tells you only half of the entire story.

In order to better evaluate the financial performance of their company and to make informed business decisions, entrepreneurs should also use financial indicators and ratios.

Financial indicators are used in order to measure the performance and position of a company compared with other businesses in the same field or with previous periods.

As it helps you to correlate different sets of data, these indicators will help you to accurately position your company and plan your next steps.

In this document you will find answers to the next questions:

- *What is a financial indicator?*
- *What types of indicators should I monitor for my business?*
- *How to use financial indicators to better understand the operations of my business?*
- *How to take business decisions based on my indicators?*
- *What are some acceptable values in order to have a healthy company?*

The importance of financial ratios

Before we start, it's important for you to know that in order to calculate the next indicators and ratios you will need some data from your balance sheet, P&L, and cash flow statement.

The **cash flow statement** is a financial document which will tell you how much money you have at hand at a given period of time. The cash flow statement contains daily inflows and outflows from your operating, investing and financing activities.

The **income statement** (P&L or profit and loss statement) measures the financial performance of a company and can say whether a business makes profit out of its activity or not. From this type of document you can obtain various information, such as turnover, total income and expenses, amortization and profit value (operational profit, gross profit or net profit).

The **balance sheet** offers an overview over your company and contains information regarding what your business owns (assets) and owes (liabilities). If you read it you'll find out what is the value of your inventory, how much money you need to pay to creditors or what is the amount invested by shareholders.



Liquidity ratios

By using liquidity ratios you will be always aware if your company can pay its current financial obligations, such as salaries, utility bills, suppliers, taxes.

These indicators are especially relevant for small companies which are more prone to lack of liquidities. However, this does not mean that big players should avoid it. The bigger the company, the higher the need of cash and the risk.



Current ratio

The current ratio is a liquidity indicator which measures the company's ability to pay all its current debts (liabilities) by using the current assets (those that can be easily converted into cash).

Some examples of liquid assets are cash available, accounts receivable and inventory.

You can calculate current ratio by using this formula:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}^1$$

If the current ratio is lower than 1, it's possible that you will not be able to pay all your current liabilities with your current assets. Therefore, a value close to 1 or higher is desirable for almost every industry.

More explicit, this means that you can only pay once all your liabilities with the available current assets. If your current ratio is 2, then the amount of assets is double compared to your liabilities. Another way to say it is that for every 1\$ you owe, you own 2\$ that you can use to pay.

However, a value which is too high is also something that you will not want. A high current ratio can mean that the company is not efficiently using its money for new investments, has too much inventory which ties up capital or that it does not pay dividends to its shareholders.

¹Both metrics can be found in the company's balance sheet.

In order to keep your company healthy and growing, you need to establish a balance between current assets and liabilities. If you want to start setting goals regarding your current ratio, you should take into account:

- *how much cash you need in order to pay all your current debts (monthly installments, suppliers, salaries, etc);*
- *what is the amount of inventory you need for the next period. You can also use the inventory turnover which we discussed below;*
- *what new investments you need to make and what is an approximate amount of money you need for the next period.*

Keep in mind that the balance sheet is a dynamic financial statement. This means that every time you make a transaction, the balance sheet changes too and this can also influence your liquidity ratio.



Quick ratio

Quick ratio or acid test ratio is a liquidity indicator which measures a company's ability to pay all its current debts by using only the very liquid assets, such as cash and accounts receivables. Compared to the current ratio, the quick ratio does not take into account the inventory. This is because cash and account receivables are considered to be the most liquid assets of a company as it can be easily converted into money without waiting too much.

You can calculate quick ratio by using this formula:

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

You can interpret the quick ratio as you do with the current ratio. If the value is lower than 1, then there's a chance you are in trouble. Consequently, if the value is too big this, it can mean that you do not use the capital at its maximum efficiency.

However, there are industries where it's normal to have a lower quick ratio. Take as example the heavy industry or the real estate. Companies in these fields usually work with very long payment terms and cash conversion cycles (we'll talk about it later). What we mean is that they have a lot of money tied up in the business so it's normal to have a lower value for this indicator.

Keep in mind that a single ratio will not offer a complete image of your business so it's important for you to correlate it with other types of information. For example, let's say that the quick ratio is close to 1 so we can assume that you are safe, but the due date for your next installment is tomorrow. In this situation, if you don't have any cash available your business will suffer. What will help here is a cash flow plan which will monitor your daily inflows and outflows and will give you valuable information regarding cash available.

Cash ratio

Cash ratio is a liquidity indicator which measures a company's ability to pay its short term liabilities using only its cash and cash equivalents. Compared to the current or quick ratio, cash ratio does not take into account inventory or accounts receivables because these require time to be converted into cash.

You can calculate cash ratio by using this formula:

$$\text{Cash ratio} = \frac{\text{Total cash or cash equivalents}}{\text{Current liabilities}}$$

Cash ratio is an indicator considered to be less risky compared to the current or quick ratio. That's because a company cannot be always sure that the inventory it owns will be converted into cash or that the invoices will be cashed in due time.

Also, it's perfectly normal that this indicator is not close to 1, as in the examples above. There are very few companies that can pay all their liabilities with their available cash. That's because money that is not currently tied up in the business will be rather used for new investments. In the opposite way, a high cash ratio may convey the message that the company is saving up for some rainy days.

Profitability ratios

Profitability ratios will help you to understand more about the ability of a company to generate profit.

They are numerous and very popular, but in this ebook we mentioned only the ones that are used the most.



Gross profit margin

The gross profit margin is a profitability ratio measuring the amount of gross profit as a percentage from total revenue.

Gross profit is the difference between revenue and costs of goods sold (COGS). If you register gross profit that means that your products or services are profitable, but this does not necessarily mean that your company is overall profitable. This can only be seen after deducting all costs, including operational costs and taxes.

Gross profit margin is depicted as a percentage and it can be calculated with this formula:

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Net turnover}^2} * 100$$

Use gross profit margin in order to know what percentage of your total turnover is represented by profit that can be used for further expenses. It's important to monitor this ratio in order to spot any problems that might appear (drop in sales, too high costs).

There's no such thing as an ideal gross profit margin, as this ratio varies based on industry or activity. Usually a company that sells high valued services registers higher profits compared to a manufacturing business. That's because the first company's major expense category is represented by salaries, while in the second example the owner also has to pay for inventory, equipment, bigger space, etc.

²Deduct VAT from turnover if necessary.

Operating profit margin

The operating profit margin is a profitability ratio that measures the amount of operational profit as percentage from total revenue.

Operating profit or EBIT (Earnings Before Interest and Taxes) is the difference between turnover and COGS plus operating costs (administrative, marketing, etc). Operating profit helps you measure the company's efficiency in delivering the services/products to the end user.

Operating profit margin is depicted as a percentage and it can be calculated with this formula:

$$\text{Operating profit margin} = \frac{\text{Operating profit}}{\text{Net turnover}} * 100$$

Operating profit margin offers an overview of the operational efficiency as it takes into account only the types of costs that can be controlled by the manager. You'll see that expenses like taxes or installments are not added here because there's little that the entrepreneur can do regarding it.

You can use operating profit margin in order to take informed decisions regarding your pricing strategy or for reducing costs, if the case. There's no globally recommended value for this ratio, as it is highly influenced by industry and type of business activity.

Net profit margin

Net profit margin is a profitability ratio which calculates the amount of net profit as a percentage from total revenue.

Net profit is all your company is left with after paying all expenses, including taxes. You can also refer to net profit as EAT or Earnings After Tax.

Net profit margin is depicted as a percentage and it can be calculated by using this formula:

$$\text{Net profit margin} = \frac{\text{Net profit}}{\text{Net turnover}} * 100$$

Net profit margin is the percentage that's left to the company from each \$1 revenue. Therefore, if the net profit margin is 10%, then from \$10 revenue, the company will gain \$1 as profit and \$9 are used for all expenses.

Try to gather more information regarding your competitor's net profit margin and see where your company stands. You can set some goals towards increasing the net profit margin, but remember that you cannot control all costs that influence this ratio.

Also, don't forget that cash is king and there are situations in which companies that are profitable on paper cannot afford to pay their bills in a real situation. If you would rather know what money you have at hand at different moments in time, we encourage you to start monitoring your cash flow.

Return on Assets (ROA)

Return on assets is a profitability ratio measuring how efficient a company uses its assets to generate profit.

Return on assets is depicted as a percentage and it can be calculated by using this formula:

$$\text{ROA} = \frac{\text{Net profit}}{\text{Total assets}^3} * 100$$

A high ROA indicates that the company is able to generate a lot of profit out of its assets. However, this can also mean that the management is not investing in renewing its assets base so it's possible that the long term prospects will be compromised.

ROA is used to compare the efficiency of a company in a certain time-frame or multiple businesses from the same industry. This is very important indicator to remember as usually businesses selling services register a lower ROA compared with manufacturing ones. That's because a clothing factory needs a lot of equipment to start generating profit, while a software development company can only use some laptops to become successful.

³This value represents the total value of the assets a company owns in a specific time period and it can be encountered in the balance sheet.

Return on Equity (ROE)

Return on equity is a profitability ratio which measures how efficient a company uses the capital invested by its shareholders in order to generate profit.

Return on equity is depicted as a percentage and it can be calculated by using this formula:

$$\text{ROE} = \frac{\text{Net profit}}{\text{Average shareholders equity}^4} * 100$$

The higher the ROE, the more profitable is the investment made by the shareholders. This is something that every investor wants, thus the popularity ROE has gained.

However, as in most cases, ROE should not be the only indicator used to make business decisions. For example, a company can raise the value of its net profit not by increasing the shareholder's equity, but by contracting loans. This will positively influence ROE, but it does not mean that the shareholders will receive higher amounts of dividends.

On the other side, a too high ROE could point out that the company is not used at its maximum potential (money is spent on dividends rather than on operations).

⁴You can find this value in the balance sheet. Both net profit and shareholders equity should be calculated for the same time period.

Efficiency ratios

Efficiency ratios help you to understand how productive you are in using the company's assets.

In order to have a positive impact over your cash position, it's important to work with some data from your balance sheet as well. The less amount of tied up money, the more investments you will be able to make in order to grow your business.



Inventory turnover

Inventory turnover is an efficiency ratio that measures how many times a company sells its inventory during a given period of time (usually a year).

You can calculate inventory turnover by using this formula:

$$\text{Inventory turnover} = \frac{\text{COGS}^5}{\text{Average inventory}^6}$$

Inventory turnover is often used together with days in inventory (explained below) in order to make decisions regarding the daily business operations.

You can use this type of data in order to find the proper time to make a new inventory order. This way you reduce cash tied up in inventory and the storing costs. You positively influence profit by assuring a balance between turnover and COGS. Also, you reduce the risk of being left with inventory that is affected by seasonality.

The higher the inventory turnover, the tighter your management of inventory and the better your cash position. So long as you have enough inventory to meet your current clients needs, the more efficient you can be, the better.

⁵You can find this value in your income statement (P&L).

⁶Calculate the average inventory by adding the value of inventory at the beginning of the period to the value of inventory at the end of the period and divide by 2.

Days in Inventory (DII)

Days in inventory is an efficiency ratio measuring the average number of days inventory is stored before selling it.

You can calculate DII by using this formula:

$$\text{DII} = \frac{\text{Average inventory}}{\text{COGS}} * 360^7$$

DII is influenced by the industry in which the company operates. It is normal that DII is lower in the food industry compared to the clothing industry. Also, in order to get the correct information, be careful to compare DII of businesses that have similar size and activity.

You can use DII in order to take decisions regarding new acquisitions, marketing or sales campaigns.

A low value of DII translates into a higher operational efficiency. A high value, on the other side, can mean that a company is selling less or harder, but this is not always the case!

For example, if a factory producing surgical masks anticipates a sudden decrease in available products on the market, it can decide to keep its inventory in order to sell it later at a higher price.

⁷It is commonly calculated for a year.

Days Sales Outstanding (DSO)

Days sales outstanding, also known as average collection period, is an efficiency ratio measuring how long it takes your clients to pay your invoices.

You can calculate DSO by using this formula:

$$\text{DSO} = \frac{\text{Accounts receivable}}{\text{Turnover}^8} * 360$$

DSO highly influences cash flow so you'll need to carefully monitor it.

Try to keep a balanced DSO, not too low - it can badly influence your commercial relations - and not too high either. As in most cases businesses face the second situation, here's what you can do in order to obtain a desired DSO:

- *Check your future clients prior to signing any contract;*
- *Send all invoices on time;*
- *Offer various payment methods;*
- *Offer your clients an easy way to reach you in case they have any questions;*
- *Send reminders;*
- *Implement early payment discounts.*

⁸In this case you will need to add the turnover for a year, but you can also calculate this ratio for a semester.

Days Payable Outstanding (DPO)

Days payable outstanding is an efficiency ratio measuring how long it takes you to pay all your suppliers.

You can calculate DPO by using this formula:

$$\text{DPO} = \frac{\text{Accounts payable}}{\text{COGS}^9} * 360^{10}$$

A low DPO will enhance the company image on the market. If you manage to pay your suppliers on time then this is a valuable prerequisite for future partnerships. What is more, in this way you reduce the chance of spending money on something else which is not as urgent for your daily operations.

On the other hand, a high DPO value means increased liquidity or more cash available for investments. The challenge is to maintain a balanced DPO.

⁹You need to calculate COGS only for the period taken into consideration for this metric. In this case, it's a year.

¹⁰You can also calculate it for a semester or less.

Property, plant and equipment turnover (PPE turnover)

PPE turnover is a ratio measuring the efficiency a company has in using its fixed assets to generate revenue.

Fixed assets are represented by physical goods that a company usually uses for a longer period of time: buildings, plants, equipment, machinery. These are not very liquid assets that are mentioned in the balance sheet and depreciated over time.

You can calculate PPE turnover by using this formula:

$$\text{PPE turnover} = \frac{\text{Net turnover}}{\text{Fixed assets}}$$

If for example the value of this indicator is 3, that means that for every \$1 invested in fixed assets, the company generates \$3 as sales. It's recommended to monitor the fluctuation of PPE turnover over time or compare it with your competitors.

Be careful though with companies that lease equipment rather than own it. Leased equipment is not shown in the balance sheet, but will positively influence the PPE turnover. Also, take into consideration seasonality. An ice cream factory will register a decrease in sales during winter and this will also influence PPE turnover.

Compare the values from the same period and don't forget to take into consideration the depreciation of your equipment.

Asset turnover ratio

Asset turnover ratio measures the efficiency a company has in using its assets to generate revenue. Compared to PPE turnover, this ratio takes into account all assets, not just the fixed ones.

You can calculate asset turnover ratio by using this formula:

$$\text{Asset turnover ratio} = \frac{\text{Net turnover}}{\text{Assets}}$$

Asset turnover ratio is more relevant for small companies (compared to PPE turnover), as they do not have a lot of fixed assets registered in their balance sheet.

With asset turnover ratio SME managers can get more data on how their daily operations can influence the business. Whether you reduce inventory, convert accounts receivable, buy or sell assets, this will influence the assets turnover. The ideal situation is to increase turnover value while keeping equipment or inventory at the same level. In this situation the asset turnover ratio will grow, as you generate more sales with the same amount of materials.

Do not mistake asset turnover ratio for return on assets! Asset turnover ratio calculates the sales you can make out of your assets, while return on assets tells you how much profit you make out of your assets. Both can help you to better understand your business in order to make informed decisions.

Cash conversion cycle (CCC)

Cash Conversion Cycle is an efficiency ratio measuring the amount of time a company needs to convert its inventory into cash at hand. To calculate CCC you will need 3 different values: Days in inventory (DII), Days sales outstanding (DSO) and Days payable outstanding (DPO). You can calculate all of them based on the above instructions.

You can calculate CCC by using this formula:

$$\text{CCC} = \text{DII} + \text{DSO} - \text{DPO}$$

CCC is more relevant for companies who operate based on inventory, but it can be used by everyone.

The longer you store your inventory or the longer the due dates of your invoices, the higher the CCC. On the other hand, the longer you keep the money in your account, the lower the CCC. This is the desired solution for you, as with a low CCC comes more free cash that you can use for further investments or daily operations. You can do this if you:

- *Produce faster, thus you store less;*
- *Sell faster or more, thus you store less;*
- *Reduce your DSO, thus you bring money faster back in your accounts;*
- *Increase your DPO, thus you hold money more in your accounts.*

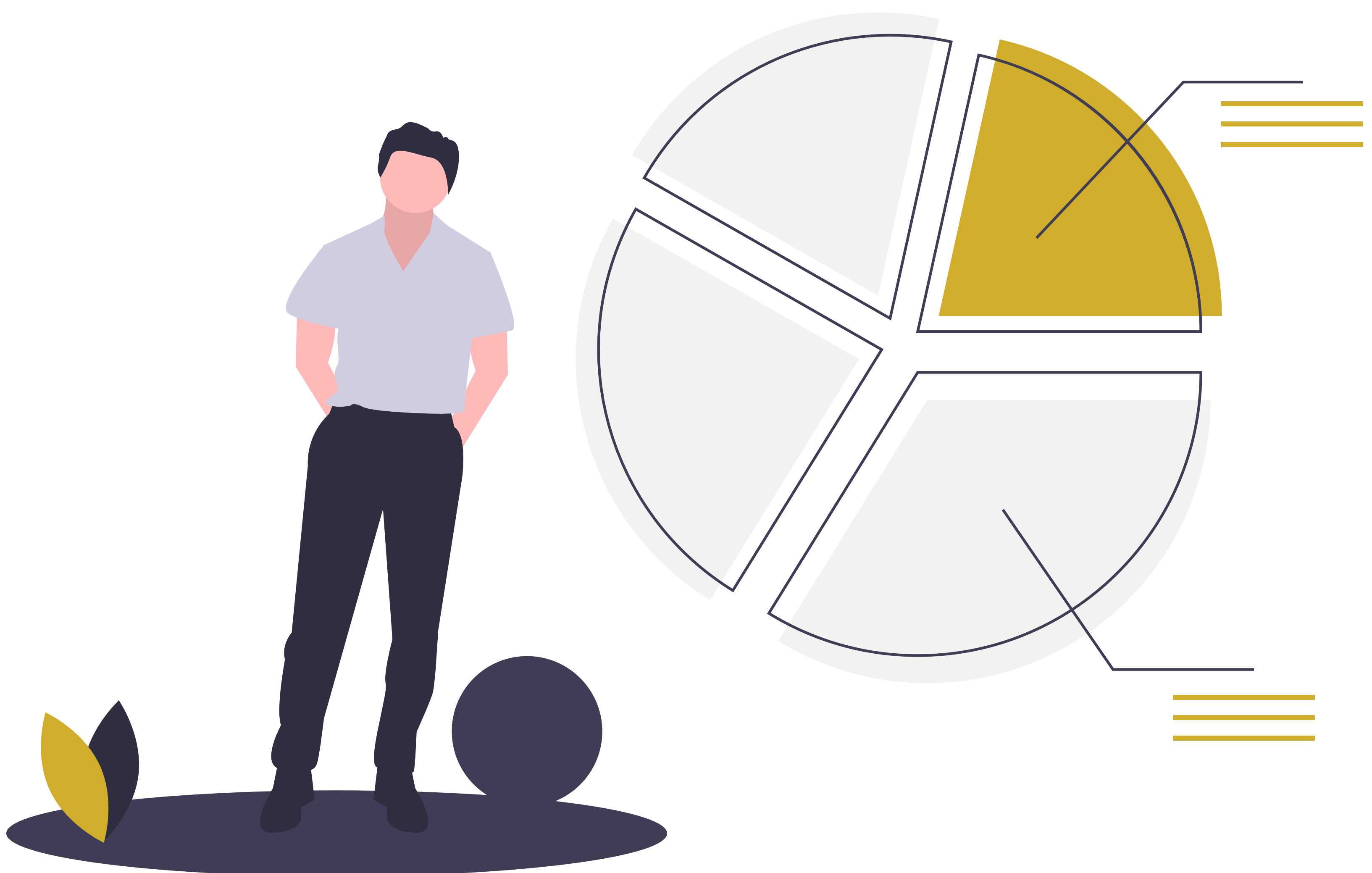
If you have a negative CCC, this means that you pay suppliers after you receive the payment from your clients. This usually happens in retail.

You can try to use CCC together with ROA or ROE because they influence each other. The lower the CCC, the more efficient the company in using the assets or the shareholders equity. If you want to make your investors happy, you would need to have a low CCC and high ROA and ROE.

Leverage ratios

Leverage ratios measure how much external money the company uses for daily operations and company growth.

This category of ratios is important because businesses rely on a mixture of equity and debt for daily operations. Measuring the amount of debt held by a company is useful in assessing whether it can pay off as they come due.



Debt ratio

Debt ratio is an indicator measuring the percentage of a company's assets provided through debt. This indicator will tell you how much debt you have for each 1\$ stored in assets.

Debt ratio is a percentage and is obtained by using the formula:

$$\text{Debt ratio} = \frac{\text{Total debts}}{\text{Total assets}} * 100$$

If your debt ratio is 80%, this means that for each \$1 owned, you owe 80 cents. A company with a debt ratio higher than 100% has more debts than assets, therefore a lower value is usually recommended. However, there are a lot of companies that grow based on debts because they find an efficient way to use the money and generate even more out of its operations.

In order to gain more data on how you use and return the money you borrow, you can correlate debt ratio with the profitability or liquidity ratios. For example, even though you have a high debt ratio, if your ROA is also increasing, then it means that you are using money efficiently and generate profit out of it - so you get the most out of your loan.

Also, if your debt ratio is high, but your current ratio is higher than 1, then you can survive without problems. Be careful with your cash flow though.

Debt to equity ratio (D/E)

Debt to equity ratio is an indicator identifying the way in which a company finances its assets, if it's rather through internal (shareholders equity) or external resources (loans).

Debt to equity ratio is obtained by using the formula:

$$\text{Debt to equity ratio} = \frac{\text{Total debts}}{\text{Total equity}}$$

If D/E is \$1.5, this means that you have more debts than equity or that for each \$1 as equity, you have \$1.5 as debts. Ultimately, this indicates that your daily operations are rather backed up by external funding, like loans.

D/E is commonly used by investors or creditors in order to see the ability of a business to grow by using its own resources.

If D/E is too high, then it will be a little difficult to raise more money through borrowing, so in this case expansion will require more equity investment.

D/E is pretty hard to use without any other (internal) data about the company. For example there are a lot of companies that use a lot of debt to finance their operations (real estate, aeronautics) or companies with a big growth boost which require some major investments in order to sustain their expanding process.

If you want to get relevant information out of this indicator, monitor its fluctuations over different periods. Be careful though and take into account the particular situation you are facing:

- *You just made an investment which is not profitable yet -> check CCC;*
- *You are aggressively growing and need a lot of cash to sustain your daily operations;*
- *You had to pay a big one-off (e.g. fine);*
- *Your strategy is to reduce profit and rather invest a lot in your company;*
- *Remember that the balance sheet is dynamic;*
- *Equity does not mean cash at hand.*

Interest coverage ratio

Interest cover ratio is an indicator measuring the ability of a company to cover its interests. Usually businesses calculate this ratio for a period of one year.

Interest coverage ratio is obtained by using the formula:

$$\text{Interest coverage ratio} = \frac{\text{EBIT}^{11}}{\text{Total interest}^{12}}$$

Interest coverage ratio will tell you how many times your company can use its operating profit to pay all the interest. Therefore, if the interest coverage ratio is 2, then you are okay because with the level of profit you have, you'll be able to cover all your interest twice. Of course, all values lower than 1 are not something that you necessarily want.

Be careful when calculating the interest coverage ratio. The values from the income statement are approximations based on invoices. Therefore, even if you have a high interest coverage ratio, there's still a chance that you'll not have enough money to cover all your expenses when they're due, so keep an eye on your cash flow.

²⁰EBIT or operating profit is found in the income statement and represents the value of the profit before paying interest and taxes.

²¹Each value must be calculated for the same amount of time; usually a period of 1 year is used.

Solvency ratio

Solvency ratio is an indicator measuring the ability of a company to meet its debt obligations. To calculate the solvency ratio you'll need the net profit, the amortization value and the total amount of debt from the balance sheet.

Solvency ratio is a percentage and can be calculated with the formula:

$$\text{Solvency ratio} = \frac{\text{Net profit + amortization}}{\text{Total debts}} * 100$$

It's important to add the amortization value as it's a non-cash expense. This means that this value has not been transferred from one bank account to another, so it reduces your profits from your P&L, but not cash available.

The higher the solvency ratio, the better the company image for the creditors. Even though in some articles a 20% solvency ratio is seen as a real success, in reality these values are influenced by industry and company size.

You have probably noticed that the solvency ratio is similar to the cash ratio and you are right. The only difference in calculating it is that the cash ratio analyses the company's ability to pay the short term debts (due in approximately 1 year) while the solvency ratio takes into account all debts, including the long term ones.

All these financial indicators are useful and relevant as they help the entrepreneurs to determine how efficient is the company's commercial activity. Following the results, they can ensure a certain kind of flexibility that allows them to adapt to difficult conditions or to seize new opportunities for profit or growth.

Some entrepreneurs prefer to use financial advisors to help them calculate all the indicators, while others prefer to use spreadsheets or dedicated software to monitor and calculate on their own. There are also managers who focus only on certain categories of indicators, depending on the needs of their business.

You can use ThinkOut to quickly view your account balance (bank accounts and cash accounts), organize your current transactions, forecast future inflows and outflows, and have more precise information about your business's cash flow.

Understand your company's cash movements, spot possible shortcomings, make informed decisions and effortlessly plan the future of your business.

