White Paper

Five Crucial Types of Financial Metrics for Growing Companies

Starting a business is a big achievement, but running a successful business a much bigger challenge. There are many common challenges that face every business whether they are large or small, such as hiring the right people, building a brand and maximizing productivity. However, there are some challenges that are unique to small and mid-size businesses, particularly those who are growing. Statistics suggest that 50 percent of new businesses will fail within their first five years of operation, and a whopping 70 percent will not last 10 years.

While there are many challenges businesses must overcome as they grow, maximizing your financial assets is at the top of the list. In today's markets, it's tough enough to turn a profit even when you do everything right. To avoid making things harder on yourself, here are some common financial management mistakes you should steer clear of:

- Failure to plan
- Poor cash management
- Not having access to timely and accurate business records
- Not knowing the true cost of goods or services sold and/or overhead costs
- Having the wrong mixture of debt and equity in the business

Financial metrics and ratios offer business owners and executives a way to evaluate their company's performance and benchmark it with other businesses.

Benchmarking is a valuable exercise. Industry-specific performance indicators provide invaluable and highly specialized information, but it is important to remember that different companies within an industry can have various measures of success.

Ratios, on the other hand, measure the relationship between two or more elements of your financial statements, and are used most effectively when comparing information over time. This gives you the ability to track your company's performance and uncover signs of trouble.

Here are 5 types of key financial metrics and ratios that are almost universally relevant across industries to measure the financial health of your business.

1. Financial Statement Metrics

Revenue Growth

The revenue growth of a company tells you how much sales increase or decrease over a period of time. Growth is calculated by comparing a company's current revenue to the revenue from the previous period. This metric serves as an important measurement of how fast a business is expanding (or contracting).

Revenue Growth =
Revenue in Current Period –
Revenue in Prior Period/Revenue in Prior Period

Gross Profit Margin

The definition of margin, in the most basic terms, is gap or difference - one number relative to another. Gross profit margin is an indicator of how well a company is managing its growth. Declining margins over time is a red flag as it will generally be reflected in other areas, such as escalating costs or declining net revenue.

Gross Profit =
Revenue – Cost of Goods/Services Sold

Gross Profit Margin =
Gross Profit/Revenue

Net Profit Margin

Net profit margin is a simple financial metric, but it's also one of the most important. A company's net income is its total profit or more commonly, the bottom line. It is usually expressed as a percentage.

Net Profit Margin =
Net Income/Sales Revenue

2. Leverage Ratios

A leverage ratio is meant to evaluate a company's debt levels and is often a measure of risk.

Debt-to-Equity Ratio =
Total Liabilities / Shareholders' Equity

Measures how much debt a business is carrying as compared to the amount invested by its owners. This indicator is closely watched by bankers as a measure of a business's capacity to repay its debts. In general, a high debt-to-equity ratio indicates that a company may not be able to generate enough cash to satisfy its debt obligations. However, low debt-to-equity ratios may also indicate that a company is not taking advantage of the increased profits that financial leverage may bring.

Debt-to-Asset Ratio =
Total Liabilities / Total Assets

Shows the percentage of a company's assets financed by creditors. A high ratio indicates a significant dependence on debt and could be a sign of financial weakness.

3. Liquidity Ratios

Liquidity is the ability to sell an investment or assets at or near their value. There are two fundamental liquidity ratios that should be analyzed jointly to help your client assess a company's health. Current ratio shows a company's general liquidity while quick ratio provides a shorter-term view of the cash situation.

Working Capital Ratio =
Current Assets / Current Liabilities

Indicates whether a business has sufficient cash flow to meet short-term obligations, take advantage of opportunities and attract favorable credit terms. A ratio of 1 or greater is considered acceptable for most businesses.

Cash Ratio =
Liquid Assets / Current Liabilities

Indicates a company's ability to pay immediate creditor demands, using its most liquid assets. It gives a snapshot of a business's ability to repay current obligations as it excludes inventory and prepaid items for which cash cannot be obtained immediately.

4. Profitability Ratios

Return on Shareholders' Equity =
Net Income / Shareholders' Equity

Indicates the amount of after-tax profit generated for each dollar of equity. A measure of the rate of return the shareholders received on their investment.

Return on Total Assets =
Income from Operations / Average Total Assets

Measures efficiency of assets in generating profit.

5. Operations Ratios

Accounts Receivable Turnover =
Net Sales / Average Accounts Receivable

A higher turnover rate generally indicates less money is tied up in accounts receivable, as customers are paying quickly.

Average Collection Period =
Number of Working Days X Average Accounts Receivable / Total Amount of Net Credit Sales in Period

Indicates the amount of time customers are taking to pay their bills.

Average Days Payable =
Days in the Period X Average Accounts Payable / Total Amount of Purchases on Credit

Measures the average number of days it you are taking to pay suppliers.

Conclusion

Taken together, all of these benchmarks can be a great barometer to the financial health of a company, particularly when you look at trends over time. Benchmarking current metrics against past performance and industry averages gives you a more complete idea of your company's financial health. Implementing a process for measuring and tracking these metrics and ratios on a regular basis is key to enabling management to react to challenges and opportunities alike. Investing in the right systems is an investment that will pay off both short and long term. Velosio helps companies evaluate and implement Dynamics 365 Business Edition financial systems that support key business processes that provide insight into key metrics that can help make informed decisions.