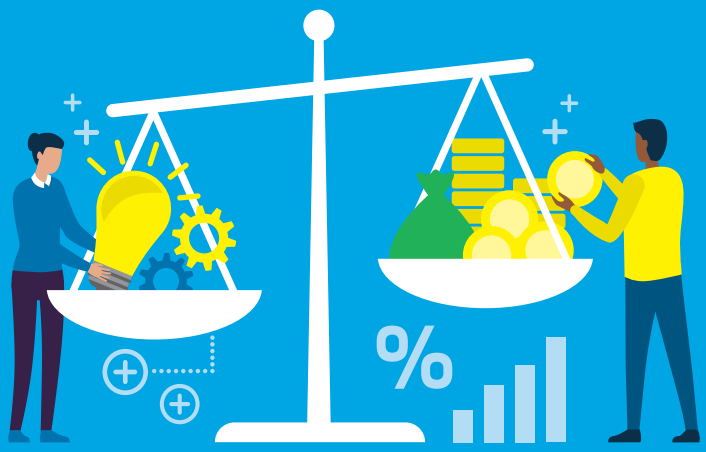
NHPA



Financial Glossary

DEFINITIONS OF TERMS & RATIOS

Understanding the application of useful retail metrics and how to calculate them is critical for every member of a home improvement team. In this document, take a tour of some of the most common financial terms used in retail. Share this document at your next team meeting or print it out and display it in the breakroom to keep employees motivated and thinking of how they can strengthen the operation. To learn more about key retail metrics, visit **hardwareretailing.com/key-retail-metrics**.

NHPA
STRATEGIC
SERIES

Square Footage, Employees & Customers

Sales Per Square Foot

Net Sales ÷ Square Feet of Selling Area

This classic measurement remains one of the most important gauges of a store's productivity.

Gross Margin Per Square Foot

Gross Margin ÷ Square Feet of Selling Area

This ratio combines sales floor productivity with gross margin data to show how much profit is being generated per square foot.

Inventory Per Square Foot

Inventory ÷ Square Feet of Selling Area

Stores that stock more inventory per square foot typically generate higher sales. However, managers also need to consider other inventory measurements, such as turns.

Sales Per Employee

Net Sales ÷ Total Full-Time Equivalents

In calculating this ratio, two part-time employees are considered equivalent to one full-time employee. While comparisons to industry benchmarks are important, it is typically most useful when a retailer compares the number to past performance.

Sales Per Customer

Net Sales ÷ Number of Customers

By measuring the average sale per transaction, a store can gauge how well its merchandising and sales staff are driving sales.

Cash Cycle

Cash Cycle

Average Collection Period
+ Inventory Holding Period
– Accounts Payable Period

By combining the three ratios that make up this formula, retailers can measure the length of time between the purchase of products and the collection of accounts receivable. Shortening this cycle provides the company more cash.

Average Collection Period

Accounts Receivable ÷ (Credit Sales ÷ 365)

This is the average time period for which receivables are outstanding. A general target is 45 days, but this ratio is most meaningful when a business compares its numbers from year to year. As a rule, the average collection period should not exceed 1-1/3 times a company's typical terms. Extended receivables eat up working capital and mean someone else is using your money.

Inventory Holding Period

365 ÷ Inventory Turnover

Measures, in terms of days, how long inventory stays on the shelf.

Accounts Payable to Payout Period

Accounts Payable ÷
(Cost of Goods Sold ÷ 365)

This measurement reveals how timely the business pays suppliers.

Liquidity & Debt Ratios

Current Ratio

Current Assets ÷ Current Liabilities

It measures a company's ability to pay its debts as they mature. As a general rule, target 2.0x to 3.0x.

Quick Ratio

(Current Assets – Inventory)
÷ Current Liabilities

This ratio measures a company's ability to pay its short-term debts on short notice so only highly liquid assets are considered. Target a minimum standard of 1.0x. If this number remains low for a long period, additional financing may be in order as a short-term solution.

Cash to Current Liabilities

Cash ÷ Current Liabilities

Also known as liquidity ratio, it is of interest to short-term creditors because it is the most stringent test of the ability of a firm to meet current obligations.

Accounts Payable to Inventory

Accounts Payable ÷ Inventory x 100

This formula reveals how much a company's inventory is being financed by suppliers.

Defensive Interval

Cash ÷ (Operating Expense Other Than Depreciation ÷ 365)

This conservative measurement reveals how long a company could operate on its cash reserves. A worst-case analysis calculates the number of days a business would be solvent if sales and collections stopped. A good minimum is 10 days.

Debt to Equity

Total Liabilities ÷ Net Worth

This measures the owner's investment in comparison to financing provided by creditors. A mix of $1 of debt to $1 of equity is usually considered practical.

Financial Statements

Income Statement

The income statement presents in a single format revenue derived from the sale of merchandise and expenses incurred to produce these sales. All financial report income statement data are presented as a percent of Net Sales.

Balance Sheet

The balance sheet is a statement of financial position at a given point in time; the report presents year-ending balance sheets. The balance sheet equation is expressed as Assets equal Liabilities plus Net Worth. All financial report balance sheet data are presented as a percent of Total Assets.

Strategic Profit Model

The Strategic Profit Model combines the principle elements of the income statement and balance sheet in a profit planning equation. It helps retailers evaluate operational performance in terms of the most important criteria: Return on Net Worth.

The formula is:
Profit Margin
x Asset Turnover
= Return on Assets
x Financial Leverage
= Return on Net Worth

Using financial ratio analysis, the model clearly identifies three operational areas that affect Return on Net Worth: Profit Margin, Asset Turnover and Financial Leverage

Profit Margin

This is the most important path to profitability. Managers can increase sales, decrease cost of goods sold and improve gross margins. While there is little management can do to control many expenses, a careful review of each expense line may reveal potential cost-savingareas. Refer to the benchmarks set by high-profit stores to develop targets.

Asset Turnover

Asset Turnover reflects the sales the firm produces per dollar invested in assets. It is calculated by dividing Net Sales by Total Assets. The key areas to focus on for immediate impact are managing inventory investments and controlling accounts receivable. While a high ratio indicates a good use of resources, a ratio too high can be a warning that a company is stretching its resources too far.
A good target is 2.5x.

Return on Assets

This ratio measures the utilization of assets to produce profits and is a good indicator of a company's ability to survive and prosper. Higher percentages are generally considered positive, but excessive numbers may indicate too few assets and the potential for financial strain.

A minimum standard is 5 percent, a typical target is 10 percent and a very good ratio is 20 percent.

Financial Leverage

By dividing Total Assets by Net Worth, managers can gauge their reliance on outside financing. A standard target is 1.5 or more. However, too high a number may mean the business is acting too conservatively and not realizing its full potential.

Return on Net Worth

Companies must earn an adequate return to satisfy the owner's needs. Minimum standards are about 10 percent. A good target is 20 percent, and a very good business will generate a 40 percent return.

Activity & Profitability Ratios

Inventory Turnover

Cost of Goods Sold ÷ Inventory

Normally a high turnover rate means good inventory management, while slower turnover indicates too much inventory for the sales it generates.

Sales to Inventory

Net Sales ÷ Inventory at Cost

This is another method of measuring inventory turns. It provides an indication of the amount of merchandise on hand relative to the amount of sales volume it generates.

Gross Margin Return on Inventory (GMROI)

Gross Margin ÷ Inventory x 100

This ratio measures the amount of gross margin dollars generated by each dollar tied up in inventory. GMROI allows managers to evaluate products and departments that have varying gross margins and inventory investment requirements. It helps retailers compare high-turn/low-margin lines against slower-moving/high-profit ones.

Sales to Working Capital

Net Sales ÷ (Current Assets – Current Liabilities)

This ratio indicates how many dollars in sales the company makes for every dollar of working capital. A low number indicates a retailer is not employing working capital efficiently or profitably. Areas to concentrate on to improve this ratio are inventory turnover, reducing the time to collect accounts receivable and gaining more favorable payment terms.

Times Interest Earned

(Profit Before Taxes + Interest) ÷ Interest

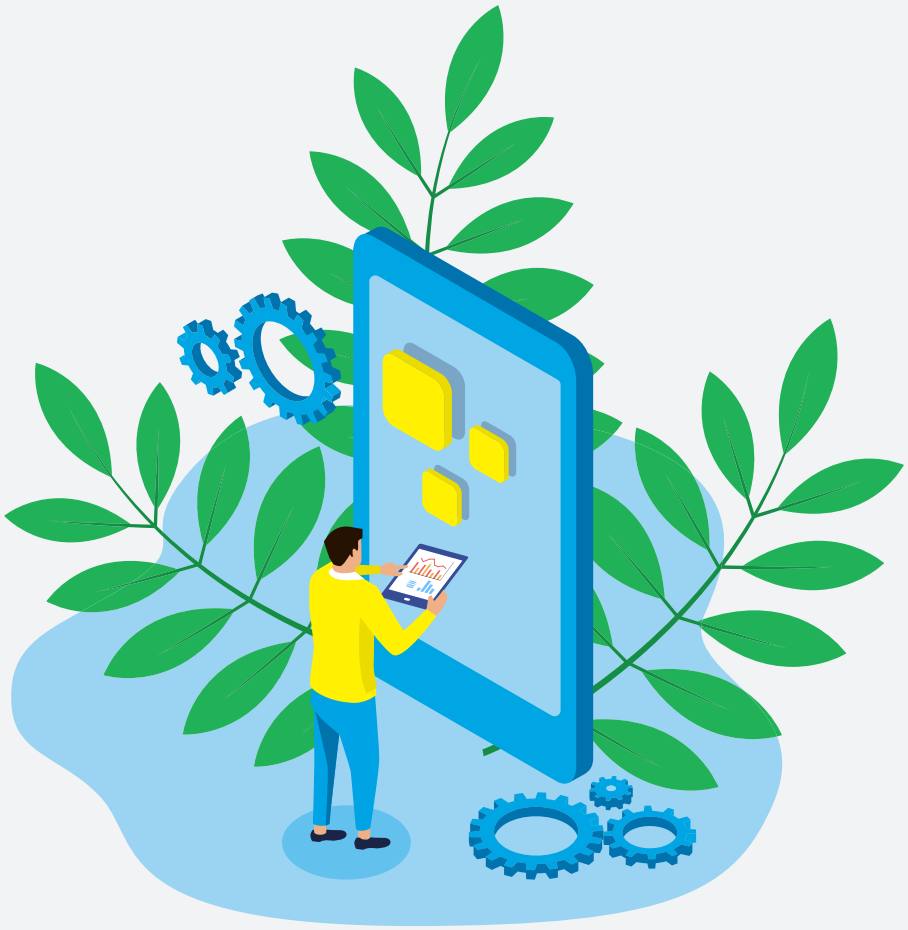
This ratio measures the extent to which operating income can decline before the firm is unable to meet its annual interest costs. It is used to assess a firm's ability to pay its liabilities, and it should be 2.0 or greater. A value of 1.0 or less suggests that the firm is not earning sufficient amounts to cover interest charges.

EBIT To Total Assets

Earnings Before Interest and Taxes ÷ Total Assets x 100

This may be the best measurement of operational profitability because it ignores the negative effects of interest expense on profitability. EBIT to Total Assets should exceed the average borrowing rate for a company to justify the use of borrowed funds. A difference of two percentage points is desirable.

STRATEGIC SERIES



This is just some of the information contained within the North American Hardware and Paint Association's annual *Cost of Doing Business Study*. To learn more and receive a free copy of the 2021 study, visit **YourNHPA.org/codb**.