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DEBIT CREDIT

By Filbert Tsai

Value of Financial Metric

. I often receive queries from start up founders, presenting me a set of metrics they've learned through various financial literacy programs. Most finance courses for entrepreneurs delve straight into understanding financial statements then dig right into ratio analysis and financial metrics

What *is* the value of a financial metric? The value of a financial metric is only relevant when you have a point of comparison. Other than that, there's none. Yes, it's a good indicator of "something" that the metric represents, but you need to have a benchmark.

A debt to asset rate won't tell you that you're doing well unless you compare yourself to a similar company. A gross profit ratio won't paint a story of financial success for your startup. Your five-year projected growth forecast won't prove that your business will become successful.

What I'm saying is that we need to stop being too engrossed on metrics. We love measurable metrics to determine our success and see how we compare to others and where the business is going. But we shouldn't rely on these.

Startup founders tend to ask me a lot about key performance indicators (KPIs) that they need to look out for. I *never* tell them to look at financial metrics. It's not because they're not helpful, but they are dangerous to untrained eyes.

Let me give you an example. Let's say a company improved its sales by P 10 Million during the year (say a 10 percent increase from the prior year). But, as a result of the additional sales, additional capacity costs have decreased the gross profit ratio (GPR) from 60 percent to 55 percent. For a metric-oriented entrepreneur, this does not look good at all. Costs could have been slashed to maintain or improve GPR. But in reality, the business has actually generated roughly an additional P5.5 Million of gross profit during that year. Now the situation doesn't look all that bad, right?

Let's twist the story a bit now. Assume that the P 10 million in additional sales actually resulted in an increased GPR (from 60 percent to 65 percent) because excess capacity was used in the production of goods. That seems to be really good, right? But beneath the surface, there is an additional advertisement expense of P7 Million, which does contribute to future sales. This doesn't really look great. Your simple ratio analysis might not be able to capture these nuances.

Hopefully, from the example above, you get my point. Financial ratios are only as good as how much you understand the underlying numbers and how you get to where you want to go. Be careful with all the shiny dashboards and easy-to-calculate metrics. More often than not, they're noise rather than signals.

Filbert Tsai is a Filipino accounting advisor in the UK with global and public sector experience. He's key areas of interests are start-ups and MSMEs. His blog and page, Ask the Accounting Advisor, provide relevant insight for start-ups and MSMEs in the Philippines.

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