

Cash Flow To Sales Ratio: Formula, Example, Analysis



Cash Flow to Sales Ratio

The operating cash flow to sales ratio is a popular metric used to compare current cash flow against sales revenue. In an ideal situation, when sales revenue increases, cash flow should increase as well. However, this may not always be the case, particularly in situations where accounts receivable balances are not collected timely.

Used by potential investors, the cash flow to sales ratio also provides a clear view of a company's current financial position and how well they are managing collections. But to gain a more complete picture of any business's financial health, it's important to look at other financial ratios for evaluation and comparison purposes.

Before calculating your operating cash flow to sales ratio, you'll need to understand both operating cash flow and free cash flow.

What is operating cash flow?

Operating cash flow measures the revenue a business earns from daily business activity. Operating cash flow includes all noncash expenses such as depreciation and amortization. By regularly calculating and analyzing operating cash flow, business owners can gauge current business profitability and growth potential by determining whether a company can generate and retain the appropriate amount of cash for operations or whether it needs to look for outside financing. There are two ways to present operating cash flow, the indirect method, and the direct method. Both methods are acceptable under generally accepted accounting principles (GAAP).

The indirect method is used for companies using accrual accounting and includes numerous non-cash accounts such as depreciation and amortization, accounts payable, and accounts receivable. Since mid-size to large businesses use the accrual method of accounting, the indirect method is the most common way to present cash flow from operations. When using the indirect method of calculating operating cash flow, you would use the following formula:

Operating Income + Depreciation - Taxes + Change in Working Capital = Operating Cash Flow

The direct method is when a business records all transactions on a cash basis. As a result, your cash flow statement displays actual cash inflows and outflows for that specific period.

Calculating the direct method is simple:

Incoming Cash - Outgoing Cash = Operating Cash Flow

Most businesses use a statement of cash flows to record current operating cash flow, with the statement produced quarterly or annually, depending on business size.

When calculated regularly and used as a comparison tool, operating cash flow to sales ratio and free cash flow to sales ratios provide good financial analysis for business owners, CPAs, and CFOs to use at the present and going forward.

What is free cash flow?

Free cash flow is a metric that is used to determine the value of a business after all capital expenditures have been paid. Common capital expenditures include maintenance, buildings and equipment, machinery, and land. Free cash flow is important because it tells shareholders and potential investors how much cash is available for dividends, asset purchases, or debt repayment. Free cash flow balances can also drive business decisions such as investments or expansion.

To calculate free cash flow, you'll first need to calculate operating cash flow.

Operating Cash Flow - Capital Expenditures = Free Cash Flow

Once that's completed, you'll simply subtract any capital expenditures from the operating cash flow total.

What is the difference between operating cash flow and free cash flow?

The table below summarizes the main differences between operating cash flow and free cash flow.

Operating Cash Flow	Free Cash Flow
<ul style="list-style-type: none">Includes cash generated by normal business operations not including investment income	<ul style="list-style-type: none">Measures cash generated after capital expenditures such as buildings
<ul style="list-style-type: none">Is used to measure efficiency	<ul style="list-style-type: none">Measures business liquidity
<ul style="list-style-type: none">Provides accuracy and is difficult to alter	<ul style="list-style-type: none">Provides information on company value to investors and shareholders
<ul style="list-style-type: none">Can be used to determine growth potential	<ul style="list-style-type: none">Shows impact of maintaining or expanding asset base
<ul style="list-style-type: none">Uses information found on an income statement	<ul style="list-style-type: none">Uses information found on an income statement and balance sheet

Though business owners can derive valuable information from both operating

cash flow and free cash flow individually, it's best if they're used together.

How to calculate the operating cash flow to sales ratio

The operating cash flow to sales ratio is used to compare the company's sales to the current cash flow. Performing this calculation allows businesses to view the company's ability to generate cash from sales.

The formula to calculate operating cash flow to sales is as follows:

Operating Cash Flow / Net Sales

Both operating cash flow and net sales totals are easily obtained from your financial statements such as an income statement.

For example, AAA Manufacturing Service is wanting to calculate its operating cash flow to sales ratio. Their operating cash flow for the year is \$1.1 million with net sales of \$2,225,000.

$$\mathbf{\$1,100,000 / \$2,225,000 = 0.49 \text{ or } 49\%}$$

This calculation indicates that AAA Manufacturing Service can convert 49% of its sales into cash.

How to analyze your ratio results

For a business to survive and thrive it must retain enough cash. Good cash flow means opportunities for growth and the ability to reinvest in the business. A higher ratio can also mean more investors and better credit terms from financial institutions. In general terms, an operating cash flow to sales ratio of 10% to 55% is considered good, with a higher number indicating a better ability to convert sales directly into cash. However, the best use of calculating your operating cash flow to sales ratio is to compare it to others in a similar industry. And for newer businesses, the ratio must be tracked regularly to determine any alarming trends that may need to be addressed.

What is the free cash flow to sales ratio?

The free cash flow to sales ratio is similar to the operating cash flow to sales ratio discussed earlier, with one exception. A crucial ratio for shareholders and potential investors, the free cash flow to sales ratio measures operating cash flow after deducting sales-related capital expenditures. Calculated similarly to the operating cash flow to sales ratio, you'll also have one additional step; subtracting all sales-related capital expenditures from your operating cash flow total before calculating the ratio. Like the operating cash flow to sales ratio, the free cash flow to sales ratio should be calculated regularly to watch for trends and should be used with other ratios to get a more complete picture of your company's financial health. In addition, the free cash flow to sales ratio is best used when comparing results to those of similar companies.

How to calculate the free cash flow to sales ratio

Calculating the free cash flow to sales ratio requires an additional step, subtracting capital expenditures from operating cash flow.

For example, we already know that AAA Manufacturing Service's operating cash flow is \$1.1 million. But in the previous example, we didn't account for capital expenditures. For this example, we'll say that AAA Manufacturing's capital expenditures totaled \$350,000. To begin calculating the free cash flow to sales ratio, we'll first have to subtract capital expenditures from operating cash flow.

$$\mathbf{\$1,100,000 - \$350,000 = \$750,000}$$

That means that your free cash flow total is \$750,000. You can now complete the calculation to obtain your free cash flow to sales ratio

$$\mathbf{\$750,000 / \$2,225,000 = 0.34\%}$$

The results above indicate that AAA Manufacturing has a very high free cash flow to sales ratio of 34%, meaning that for every dollar of revenue that was generated, AAA Manufacturing was able to generate 34% free cash flow. This number becomes more meaningful when compared to past ratio results or when

looking at the current free cash flow to sales ratio of your competitors.

Investors looking for a reliable company to invest in typically look for a company that has a free cash flow to sales ratio of at least 5%, with a higher number more desirable.

There are ways to increase free cash flow to sales ratio totals. One is to increase sales while the other is to spend less on any capital expenditures.

What is the cash flow to sales ratio for Coca-Cola?

To give a real-world example of operating cash flow to sales ratio and corporate competitiveness, let's take a look at Coca-Cola's and PepsiCo's operating cash flow to sales ratio and their free cash flow to sales ratio.

Here's some information to get started; Coca-Cola's annual operating cash flow for 2021 was \$12.625B, with annual sales of \$38.655B. They also had capital expenditures totaling \$1.259B in 2021.

First, let's calculating Coca Cola's operating cash flow to sales ratio for 2021:

$$\mathbf{\$12.625B / \$38.655B = 0.33}$$

This result means Coca Cola generated 33% operating cash flow for every dollar of revenue earned in 2021.

Next, we'll calculate free cash flow:

$$\mathbf{\$12.625B - \$1.259B = \$11.366B}$$

This means that Coca Cola's free cash flow for 2021 was \$11.366B. Now we can calculate their free cash flow to sales ratio for 2021.

$$\mathbf{\$11.366B / \$38.655B = .29}$$

Since free cash flow to sales ratio is calculated by subtracting capital expenditures from operating cash flow, Coca Cola's free cash flow to sales ratio is lower than its operating ratio, but still quite high at 29%.

In comparison, PepsiCo's annual cash flow from operating activities for 2021 was \$11.616B, with capital expenditures of \$4.459B and annual revenue of \$79.474B.

Let's quickly calculate PepsiCo's ratios.

$$\mathbf{\$11.616B / \$79.474B = 0.14}$$

This means that in 2021, PepsiCo was able to generate 14% of operating cash flow for each dollar earned. While a good number, it's low in comparison to Coca Cola's. Let's calculate free cash flow next:

$$\mathbf{\$11.616B - \$4.459B = \$7.157B}$$

Now that we know PepsiCo's free cash flow, we can calculate their free cash flow to sales ratio:

$$\mathbf{\$7.157 / \$79.474B = .09}$$

When performing ratio analysis, we see that PepsiCo's 9% free cash flow to sales ratio is low in comparison to Coca Cola's 29%, indicating that Coca Cola does a better job of converting sales revenue into cash.

This comparison indicates why it's so important to compare ratio results with competitor's results.

Cash flow to sales ratios are helpful

When calculated regularly and used as a comparison tool, operating cash flow to sales ratio and free cash flow to sales ratios provide good financial analysis for business owners, CPAs, and CFOs to use at the present and going forward.

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