Operational Efficiency Ratio: How to Calculate and Improve It



Competing in the modern global economy takes tenacity, strategic and intelligent planning, and effective methodologies for managing data, business processes, and your company's overall operational efficiency. Even massive revenues can feel like a hollow victory if high expenses are taking a hefty bite out of your bottom line.

Trimming those expenses while still producing abundant revenue doesn't have to be hard, however.

By calculating your company's *operational efficiency ratio* (also known as the *operating ratio*), you can effectively measure how well it handles cost management while generating sales or revenue—and make the changes necessary to slash costs and strengthen your company's financial health and competitive performance.

What is the Operational Efficiency Ratio?

In the course of doing business, your company generates a range of both capital expenses (CAPEX) and operating expenses (OPEX). Both CAPEX and OPEX have a

direct impact on your company's financial health.

But for the purpose of directly calculating a company's overall efficiency at minimizing its costs while still bringing in revenue or sales (i.e., calculating the operational efficiency ratio), operating expenses are used.

Operating costs are listed as line items on your company's income statement.

They generally include most of your company's expenses, barring interest paid and taxes. They are variable, frequent, and generally include, but are not limited to:

- Sales, general, and administrative (SG&A) expenses.
- Staff commissions on sales.
- Depreciation of fixed assets used outside of production.
- Property taxes.
- Salaries and wages.
- Office supplies.
- Bank fees.
- Rent and utilities.
- Accounting fees.
- Legal fees.
- Maintenance and repairs.

Operating expenses can also include those expenses directly related to production, i.e. *cost of goods sold*. Often abbreviated to COGS, the cost of goods sold (also called *cost of sales*) include:

- Direct labor costs.
- Direct material costs.
- Repairs and maintenance costs for production equipment and facilities.
- Rent for production facilities.
- Wages and benefits paid to production staff.

It's important to note that while COGS *can* be recorded as part of operating costs, many companies treat them as separate.

This becomes important when calculating operational efficiency, as the two must be added together.

The formula used for calculating the operational efficiency ratio/operating ratio is as follows:

(Operating Expenses + Cost of Goods Sold) ÷ Net Sales = Operating Ratio

A Caveat: Operating Expense Ratio vs. Operational Efficiency Ratio

While businesses of all types calculate an operating ratio, the real estate industry has a very similar sounding, but exclusive, financial ratio called the *operating expense ratio*, unrelated to operating efficiency for businesses.

Whereas the operating efficiency ratio compares expenses with revenue, the operating expense ratio divides a real estate property's total operating expenses (less depreciation) by its gross operating income.

As a metric, it's used in a similar fashion to the operational efficiency ratio, but applies it to properties rather than businesses.

> *A company with a rising operating ratio should investigate and determine which cost control measures it needs to implement to optimize its operational efficiency and boost its profit margins.*

Uses and Limitations of the Operating Ratio

Your team can combine the operational efficiency ratio with other financial KPIs (*key performance indicators*, or those financial ratios and metrics used to monitor financial performance and health) such as return on equity, working capital, and return on assets to provide a richer portrait of your company's overall operational efficiency, and to identify areas in need of further optimization.

Generally speaking, a rising operating ratio indicates increasing operating costs compared to revenue, and is considered negative.

Accordingly, a falling operating ratio indicates operating expenses are decreasing, revenue and sales are rising, or a mix of the two.

A company with a rising operating ratio should investigate and determine which cost control measures it needs to implement to optimize its operational efficiency and boost its profit margins.

A Caveat When Calculating Operating Efficiency

Despite its usefulness in establishing and tracking operational efficiency, this particular metric does require careful and considered usage to avoid strategic missteps based on incomplete or incorrect financial analysis.

Why? Because the operating ratio doesn't include a company's debt. A company with substantial debt will likely have equally substantial interest payments due regularly—and this interest expense is *not* recorded as part of the company's operating expenses.

For investors, this can provide a false image of the company's actual operating profit and operational efficiency in the short term.

For the company itself, using this metric without context provided by other financial KPIs can lead to working capital challenges by providing incomplete data on liquidity.

Ideally, the operating ratio will be just one of several efficiency ratios used, including your average accounts receivable turnover ratio, average inventory turnover ratio, accounts payable turnover ratio, fixed asset turnover ratio, and average total asset turnover ratio, among others.

A robust datasphere provides the clearest and most strategically valuable picture of a company's performance, and the business intelligence required to chart a strategic path toward process improvement and greater efficiency.

How Do You Calculate Operational Efficiency?

Once you know the capabilities and limitations of the operating ratio, you can gain a deeper appreciation for its uses by considering a sample calculation.

Let’s break out the financial statements from Company X and calculate its operating ratio. In Q2 of 2020 Company X reported total net sales of $65 billion, with a total COGS for the same period of $40 billion. Total operating expenses for Q2 were $10 billion.

Plugging these numbers into our formula, we get:

($10,000,000,000 + $40,000,000,000) ÷ 65,000,000,000 = .77

Based on the values taken from Company X’s income statement, we see it had an operating ratio of **.77, or 77%.**

This means operating expenses are equal to 77% of the company’s net sales. To put it in slightly more chilling terms, 77 cents of every sales dollar is devoured by the cost of generating it.

This is just a snapshot, but financial institutions and other lenders, as well as investors, may be less enthusiastic to provide additional capital if this number stays too high or continues to rise.

Ideally, this value should be as low as possible, so it’s likely Company X will need to investigate ways to improve this ratio through process improvement.

How to Improve Operational Efficiency

Achieving optimal operating efficiency is a marathon, not a sprint, and it requires proactive and intelligent planning to achieve more than short-term gains to profits and productivity.

If your operating ratio is on the rise or simply too high to support your business goals, you can make changes to your business processes and toolset.

1. Collect, Contextualize, and Leverage Your Financial Data

Today’s businesses are competing in a marketplace driven by big data. Having a clear and comprehensive understanding of all the data moving through your business—from finance to marketing to social media to human resources and customer service—gives you the power to analyze that data to mine insights.

These insights help you create streamlined internal controls and workflows that lead to new products, bigger market share, and higher profit margins.

2. Practice Pareto Principle Prioritization

Economist Vilfredo Pareto's oft-cited principle states that 80% of consequences come from 20% of actions taken.

Applied to your company's operational efficiency, this can be taken to mean that 80% of your sales are coming from just 20% of your clients, or that a mere 20% of the work done by your team secures 80% of your total revenue.

No matter how you slice it, it makes excellent business sense to put your resources to work where they'll bring the biggest return.

Prioritization goes hand in hand with data collection and analysis. Once you have a complete and clear picture of your finance, sales, operations, and other activities, you can begin to develop strategies that allow you to:

1. Eliminate wasted time, effort, and talent.
2. Devote those same resources to the areas of your business that produce maximum return on investment (ROI) with minimal expense.
3. Streamline your workflows, implement continuous improvement methodologies, and analyze ongoing performance to identify areas in need of further improvement, as well as activities, clients, and product developments that could further improve profitability and productivity over time.

3. Invest in Technology

Managing to capture, organize, and analyze your data, and then put the insights you gain to good use, requires a robust set of tools.

Implementing a comprehensive software solution such as PLANERGY gives you access to artificial intelligence, advanced data management and analytics, and process automation.

With these tools, you can:

- Gain full visibility into all your performance, compliance, spend and other

data generated by your business with a fully centralized, cloud-based data management solution and accounts payable automation.
- Connect disparate software environments into a cohesive whole for faster and more effective collaboration, communication, and strategic planning.
- Analyze data in real time to generate fully customizable reports, forecasts, budgets, and financial statements management can use to improve operational efficiency through more strategic spending and business process optimization.
- Practice strategic sourcing and spending to reduce operating costs across the board.
- Improve cash flow and leverage working capital more effectively.
- Streamline high-volume, low-value tasks through business process automation. This frees team members to apply their talents where they can generate the best return (while simultaneously boosting speed and enhancing performance and accuracy by eliminating human error).
- Integrate continuous improvement as part of an overarching digital transformation
- Eliminate the expense and waste of paper-based, manual workflows, generating both immediate savings and long-term value.
- Establish, manage, and refine KPIs you can use in tandem with the operational efficiency ratio to identify new opportunities to reduce operating expenses and encourage growth and revenue creation.

A Better Bottom Line through Optimal Efficiency

In business, managing the costs that come with generating revenue is just as important to your success as bringing in sales.

Practice strategic prioritization, leverage technological tools, and optimize your workflows to keep your operational efficiency ratio as low as possible—and your profitability and productivity on the rise.

What’s your goal today?

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