Payroll to Revenue Ratio: An efficiency efficiency to track

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Overview

As no company is built with the vision and mission to fail, companies ought to find out if they are performing to the best of their ability and whether any of the strategies they are implementing to improve performance are indeed producing the desired results. In the 2011 paper "Metrics pave the path to world-class" Anderson stressed the importance of measuring performance saying that unless the performance is measured and benchmarked companies will not know how they are performing and which areas need improvement. Such blindspots restrict them from identifying and focusing necessary corrective strategies and efforts on the areas that require improvement. Also, once these strategies have been implemented, companies need to be able to track their performance so that they may ascertain which strategies have been effective and which have not yielded satisfactory results. Action plans can then be made to ensure the relevant areas are addressed.

Payroll to revenue ratio

Companies have obligations to their employees, shareholders, customers, and suppliers, thus they need to ensure they are being profitable if they are to survive. One way to do this is to attempt to improve revenue whilst keeping track of the expenses incurred in the process. All companies that have employees will likely have their payroll or wage bill as one of its major expenses. This expense, however, is delicate and a substandard attempt to alter it can have chaotic consequences. An attempt to lower the payroll expenses can result in the company losing its key employees or failing to attract top talent as a result of poor remuneration. Both of these can then carry over into a fall in morale and productivity and thus profitability. On the other hand, if the expense is not monitored correctly, the company could become less profitable, and in extreme cases fail to meet its other expenses. Thus a balance needs to be found.

It then follows that an important metric to track in a company is the payroll to revenue ratio. This is simply the payroll or wage-bill for a period expressed as a ratio or percentage of the revenue for that period. Such a ratio is important to track, as it assesses the efficiency with which a company is at using its employees to generate revenue. A lower payroll to revenue ratio is generally preferred to higher ratios, as it shows that, all things being equal, the employees are bringing much more revenue into the company than the cost the company incurs in employing them.

Calculating the payroll to revenue ratio

To calculate the payroll to revenue ratio, a payroll figure, as well as, a revenue figure must be calculated.

The payroll figure must be the total cost of employment, which accounts for all the costs incurred by a company in employing its employees. This figure must include the following figures for the period in consideration:

- Gross Basic Salary
- Transport/Fuel Allowance
- Housing Allowance
- Cellphone Allowance
- Bonus/ Incentive
- Lunch Allowance
- Entertainment Allowance
- Clothing Allowance
- Hardship allowance/COLA
- Other Allowances
- Security Guard costs
- Subsidised meals
- Medical Aid contributions
- Pension Contribution by Employer
- School fees assistance
- Clubs Fees
- Professional membership fees
- DSTV Subscriptions
- Vehicle Allowances
- Vehicle Insurance

The revenue figure to use can be the gross revenue figure, which is the total amount received from the sale of goods or services rendered, without taking into consideration any costs or expenses directly linked to the good or service. A more prudent revenue figure would be the net revenue, which is the total amount received from the sale of goods or services rendered adjusted for the expenses directly linked to the goods or services. These expenses which are directly linked to producing the goods are commonly known as the cost of goods sold.

The payroll to revenue ratio is then calculated by dividing the payroll amount for the period by the revenue amount. This will give the ratio. To express this ratio as a percentage, simply multiply it by 100.

Interpreting the payroll to revenue ratio

A payroll to revenue ratio of 0.2, or 20% (when expressed as a percentage) means that payroll-related expenses account for 20% of the revenue received over the period. This percentage (20%) by itself does not mean much and does not add much value which can be used to make vital business decisions. This percentage can either be good or bad in the sight of decision-makers, depending on the culture and the strategic approach guiding the company. This ratio can be compared to past company ratios to get an appreciation of how the company is performing on that front. Tracking a company’s payroll to revenue ratio regularly will uncover prevailing trends and show decision-makers whether the company is doing well, or needs closer attention. This allows them to then make adjustments or corrections if there is a need.

Another comparison can be made with other companies within the industry. This is important as it allows companies to compare like with like especially if the companies being compared are similar in size. Comparing with companies that are not in the relevant sector may not yield suitable comparisons as the demands of industries are different.

Industries that rely more on labour such as professional services/consulting, tourism and hospitality, agriculture, and mining are much more likely to have high payroll to revenue ratios. The opposite is more likely in the case of industries that rely less on labour and more on technology or equipment. Major expenses in these sectors are likely to be focused on acquiring and improving their equipment and technology. Examples of such capital intensive industries are oil production and refinery, automobile manufacturing, steel production, transportation (e.g., railways and airlines), and telecommunications. Comparing the payroll to revenue ratio to those in the industry standards reveals to companies how well or badly their employees are performing compared to their competition.

As alluded to in passing, the size and reputation of companies also affect comparisons. Well-known companies or organisations are less likely to have to overpay to attract top talent than their lesser-known counterparts. In addition to this, larger companies may also enjoy economies of scale which smaller companies may not be able to partake in. All these points show why it is not possible

Reducing the payroll to revenue ratio

If there is a need to reduce the payroll to revenue ratio, there are a few things that companies can do to achieve their targeted percentage.

For example, employees can be trained and cross-trained to improve a workforce's ability to fulfill their jobs whilst aiding them to reach their fullest potential. Promoting learning and growth opportunities can improve an employee's ability and capacity to perform their job. Training them on other areas of the business can make them more flexible to fill in for employees that may be unavailable. Also, provided the workload is manageable, flexible employees relieve companies of hiring an additional employee to carry out tasks that they can carry out. Thus training and cross-training employees can both reduce the payroll expenses whilst improving productivity and profitability.

Alternatively, companies can attempt to improve productivity. Assessing and attempting to improve how engaged all employees are can go a long way in improving productivity. An employee engagement survey will aid in identifying any issues that could be distracting employees or creating a working environment which is unconducive. Action plans can then be made and implemented to improve areas that need improvement. An alternative method would be to put in place performance-based incentives to encourage employees to perform better. Other productivity ratios or metrics should be tracked so companies can see the progress made, as well as, persisting problem areas.

Also, companies can implement methods and systems that encourage higher sales. Selling complementary products to existing customers or simplifying the process with which they can purchase goods can improve revenue. Companies can also attempt to improve customer satisfaction and ultimately the customer reviews, as well as getting acknowledgments and recommendations from other companies and customers through the use of social media and radio.

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