



10

CRUCIAL QUESTIONS
YOU MUST BE ABLE TO
ANSWER ABOUT
YOUR BUSINESS

Knowing the answers could help save your business

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NOTE: This guide is provided as general information only and does not consider your specific situation, objectives or needs. It does not represent accounting advice upon which any person may act. Implementation and suitability requires a detailed analysis of your specific circumstances.



Philip Good,
Co-founder, Business Lighthouse

Did you know that there were 2.3M trading businesses in Australia as of June 2018¹? Roughly a third of those are 'small' businesses that employ 20 people or less. That means that Small Businesses employ approximately 5 million people out of the 10 million across all businesses². However, the sad reality is that in the 2017/18 financial year, **53,992 businesses failed**. And there are still many business owners out there experiencing sleepless nights due to the challenges of running a small enterprise.

There are many functions that a typical business owner has to juggle – Operations, Marketing, HR, Legal and the Finance. At Business Lighthouse, our focus is assisting business owners with finance department utilising our experienced and highly-trained **Finance Team**. When it comes to Finance in particular, it can quickly become information overload for the business owner and easy to ignore. This guide will briefly detail some crucial business questions you must be able to answer about your business in order for it to survive in the challenging world of small business.

Philip Good

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Managing Director & Co-Founder, Business Lighthouse

1. Source : ABS Media release 21 Feb 2019

2. Source : Australian Small Business – Key Statistics and Analysis – Department of Industry 2012

Q1

What are my real earnings?

Also known as 'EBITDA' (Earnings before interest, tax, depreciation and amortisation) = Net Profit (NP) + Interest + Tax + Depreciation + Amortisation

This number provides a 'standardised' profit calculation that helps you understand the underlying profit of your business. It is often used as a basis for business valuations. A variation to this calculation is to also add back owners' remuneration as this smooths out variation in the way owners are paid from year to year. Comparing this number each year gives you a great idea of your real earnings.

Q2

What is my profit after the costs of production?

Also known as 'Gross Profit' (GP) = Revenue – Cost of Goods Sold or Direct Costs (COGS)

This is a critical number to know if you sell stock/inventory. It shows how much of every sales dollar is left after paying or producing your stock. This amount is available to pay your business overheads.

i.e. If Revenue is \$1,000 and COGS are \$400 (40%), then GP is \$600 (60%). That is, for every \$1.00 dollar of revenue there is \$0.60 GP which is available to pay overheads.

The higher the better because what's left will pay your overheads and yourself. How this number or ratio looks varies depending on what industry you are in.

Q3

What is my profit from 'operations'?

Also known as 'Operating Profit' (OP) = Gross Profit – Overhead Costs

Operating profit provides funds for financing costs (like interest and lease costs), tax and profit distributions like dividends. First you'll need to calculate your GP (Gross Profit) in Q2 above.

Q4

What is my 'bottom line'?

Also known as 'Net Profit' (NP) = Operating Profit – Financing Costs, and Income Tax

This is the 'bottom line' we hear about and is just *one of the important measures* of the reward for all your hard work. Though the emphasis is often on the raw dollar total amount — which is important as your business grows — however, a larger percentage measure becomes more critical for evaluating growth. For example, between 5 and 10% is often used as a minimum % to target for larger business operations.

Q5

How well is my investment going?

$$\text{Return on Assets (ROA)} = \text{Net Profit (NP)} \div \text{Total Assets}$$

This gives you an indication of the financial return on the assets in the business. It also helps with the question – ‘Would my money be better invested elsewhere?’ The ratio is often benchmarked against what you would earn with the money in the bank.

Quick Note: Some numbers in your financial accounts may be based on estimates and assumptions and sometimes you really need to use market values for assets and liabilities rather than just what is the balance sheet.

Q6

Can I ‘pay my bills’?

$$\text{Quick Ratio} = \text{Current Assets (including bank accounts but usually excluding stock)} \div \text{Current Liabilities}$$

This ratio provides an indication of your ability to pay bills when you need to. i.e. If current assets including the bank account are \$2,000 and your current liabilities including creditors are \$1,000 then the quick ratio is 2.

That is for every dollar of liability, you have 2 dollars available. A good position to be in and gives you high levels of comfort in terms of not only paying your immediate bills but funding other parts of your business.

Q7

What is my business is worth?

There are several methods = Earnings Multiple, Capitalised Future Earnings, Asset Valuation and Comparable Sales

This is rarely an easy question to answer and by any means certain calculation available, but your business is a potential asset — a large lump sum reward for all your hard work! You should periodically review what this measure is (with your business advisor), and what's driving the value of your business.

Q8

What will my 'critical' numbers look like in 12, 24 months?

This knowledge is derived from a budget of forecast

Budgets are the only 'financial' numbers that are forward looking. The budget tells a 'story', about where you think you are going. They provide a financial framework for thinking about the future. Your business should have at least one high-level budget to help provide concrete visibility around your strategy.

Q9

How much 'free' cash is my business generating?

Also known as 'Free Cash Flow' (FCF) = Operating Cash Flow – Cash Flow on Capital Expenditure

This number has become the 'go-to' critical number for banks and investors. The value is calculated from the 'cash flow statement' that reconciles the cash position at the end of a period. This critical number is less subject to the 'artistic' effort. Of course, a business can manipulate these 'numbers' as well (by not paying creditors on time for example).

Q10

What are your unique Key Performance Measures?

Every business is in a particular industry where there are certain Key Performance Measures unique to that industry. Know what that indicator is and measure it regularly.

The Don't forgets! There are several key things to keep in mind when analysing financial measures:

- **Knowledge is dynamic** – it's just a 'snapshot' in time
- **Cash** is the reality check
- **Raw numbers** don't always tell you what you need to know but 'ratios' (one number compared with another) can significantly help when analysing numbers
- **Different numbers for different businesses** – You need to find the critical numbers that drive your business, and even then, they may change over time
- **Trends** can be important — if not even more important sometimes — as the raw numbers themselves
- **'No one number'** – You cannot focus on just one critical number



Navigating your business

Have a whole team of business professionals look after your business.



Have a chat with Business Lighthouse

We want your business to have a better financial future. So, come and join us for a free coffee and chat to us about your business. Business Lighthouse will give you better advice for a beautiful financial future!



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