

“

**YOU DON'T HAVE TIME TO STUDY ACCOUNTING BUT YOU DO  
HAVE TIME TO READ THIS BOOK. IF YOU ARE IN BUSINESS,  
READ IT. OTHERWISE, YOU COULD SOON BE, OUT OF BUSINESS.”**

Dale Beaumont – Founder & CEO of Business Blueprint

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# UNFUNK YOUR BUSINESS FINANCES

HOW TO **UNDERSTAND YOUR NUMBERS** LIKE NEVER  
BEFORE AND RUN YOUR BUSINESS LIKE A BOSS

## SCOTT TREVETHAN

Business Evangelist & CEO of **FINANCIAL FANATICS**



Disclaimer: All the information, techniques, skills and concepts contained within this publication are of the nature of general comment only and are not in any way recommended as individual advice. The intent is to offer a variety of information to provide a wider range of choices now and in the future, recognising that we all have widely diverse circumstances and viewpoints. Should any reader choose to make use of the information contained herein, this is their decision, and the contributors (and their companies), authors and publishers do not assume any responsibilities whatsoever under any conditions or circumstances. It is recommended that the reader obtain their own independent advice.

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# CONTENTS

<b><u>INTRODUCTION</u></b>	1
Why you need this book	4
RECAP	6
<b><u>HOW TO SPEAK ACCOUNTING</u></b>	7
The language of numbers	9
Single vs double entry accounting	10
Key accounting terms you should know	12
Why you need to understand your accounting reports	13
RECAP	15
<b><u>STRUCTURING YOUR ACCOUNTING TEAM</u></b>	17
Start-up	17
Small Business: Up to five employees	20
Medium Business: Up to 25 employees	22
Larger Business: Over 25 Employees	24
RECAP	25
<b><u>HOW TO HELP YOUR ACCOUNTANT MAKE YOU RICH!</u></b>	27
A-class	28
B-class	29
C-class	30
D-class	31
E-class	31
What class are you in?	32
Making the most of your accountant	33
What should your accountant help you with?	34
The Holy Grail: Proactive advice	35
RECAP	37
<b><u>THREE MUST-HAVE REPORTS FOR YOUR BUSINESS</u></b>	39
Report #1: The Balance Sheet	41
Assets	42
Liabilities	43
Equity	44



One more detail	46
Current Assets	46
Non-Current Assets	47
Depreciation	47
Liabilities	49
Current Liabilities	49
Non-Current Liabilities	50
Equity	51
RECAP	53
Report #2: The Profit & Loss or Income Statement	54
Revenue	54
Cost of Goods (or Services) Sold	56
Gross Profit	58
Overheads	59
Net Profit	60
RECAP	61
Report #3: The Cash Flow Statement	62
Cash from Operations	63
Working Capital	64
Cash from Investing	67
Cash from Financing Activities	68
RECAP	69
How The Three Reports Intersect	70
A worked example of the three main reports	71
A Day In The Life Of Sam's Plumbing	72
RECAP	76
<b><u>READ BETWEEN THE LINES</u></b>	77
Balance Sheet	78
Current Assets / Current Liabilities - Current Ratio	78
Total Liabilities / Equity - Debt to Equity Ratio	82
Rate of Return on Assets (Profit / Total Assets)	84
Gross Margin % (Gross Profit / Sales)	87
A note on Inventory/Stock on Hand	89
Up to Date Accounts	90
RECAP	90

<b><u>CASH FLOW MATTERS</u></b>	91
The cash cycle	92
Why is cash so important?	92
Having a Cash Budget	93
Steps to building a Cash Flow Forecast	94
Turning items into cash	95
Inventory Turnover (Cost of Goods Sold / Average Inventory)	95
Receivable Days (Average Receivables / Sales)	95
Payables Days (Purchases / Average Accounts Payable)	96
RECAP	96
<b><u>FINANCIAL DASHBOARD</u></b>	97
Cash at Bank	99
Sales	100
Accounts Receivable	100
Accounts Payable	101
Other Key Items On Your Dashboard	101
RECAP	102
<b><u>YOUR END GAME</u></b>	103
What is your end point?	104
What is financial freedom to you?	105
The line in the sand	105
Types of Valuations	106
1) Multiple of Revenue	106
2) Discounted Cash Flow	107
3) Multiple of EBIT	107
Average EBIT	108
Removing Owner Expenditure	108
The Multiplication Factor	109
The Good News	112
Taking your valuation to the bank	113
RECAP	113
<b><u>CONCLUSION</u></b>	115
<b><u>ABOUT THE AUTHOR</u></b>	117

# INTRODUCTION

# INTER



**Unfunkt:** The process of demystifying, clearing up and using something to its full power.

The purpose of accounting is to turn the story of your business into numbers. Your job as the business owner is to understand what the numbers are telling you and take appropriate action.

If you are reading this book, firstly let me congratulate you! You are either a business owner or someone who aspires to be. Unlike most business owners, you recognise that learning about accounting, whilst not the most exciting thing to do with your time, will be vital in allowing your business to survive and thrive in times of difficulty.

Anyone can win at business when times are good. But we know that businesses go in cycles. It's during a global downturn, industry disruption or a personal crisis that unprepared business owners will struggle to survive.



**Only when the tide goes out  
do you discover who's been  
swimming naked"**

**- Warren Buffett**

That statement from Warren Buffet is so true. When cash is easy to come by in the form of loans and the demand for your goods or services is so high that your whole industry can't even meet it, you don't need to be inventive to make enough money to sustain yourself and your employees. You can go out and buy a good business with good profits and acquire staff and systems by borrowing money.

When times are good, you don't need to know too much about the industry or the value you are creating. Even if there is a drop off in profits and cash, you can fill that void by borrowing more money and sooner or later you will figure out how to sustain your business for the medium term.

But the shock inevitably happens. The economy takes a turn for the worse. Your best employee resigns unexpectedly. The banks stop lending you money and even want you to pay back some of the money you borrowed.

Now things have just got a lot harder. Unless you have some idea as to how your business is performing (the gauges) and how to improve that performance (the dials), you may be heading to the point of no return and business failure.

Of course, business failure can take on many guises. On one hand, it could be closure, liquidation of assets and bankruptcy for the business owner. Or it could mean giving up on your business vision and just fighting to stay alive – waiting for the next big boom time where you can catch up and start making some money again.

One cost that is common in all forms of business failure is the cost of time. You can never get back the time you spent on your business, and whilst experience can be a great teacher, if you want to accumulate great wealth in this lifetime, you should be using time to your best advantage. That means using the power of compounding wealth and adding steadily to your asset pool over the long term so you can avoid losses as much as possible.

To avoid these harmful losses, you really should know:

- a) How to read the dials of your business
- b) How to understand the impact those dials have

This way, you will know whether you are moving forwards towards your ultimate business vision or not.

As you read this book, you'll notice an aeroplane analogy referenced a few times. The idea is that you don't need to be a pilot but if you have an understanding of what the numbers on the dashboard mean you can save your business 'plane' from running into trouble or crashing into the ground.

## WHY YOU NEED THIS BOOK

This book will teach you all you need to know about accounting in a very short period of time.

It won't make you an accountant or a bookkeeper, but we will discuss the very important role both those professionals have in your business. Your role is to understand the key terms, reports and have an idea of what the gauges of your business are telling you so you can figure out which dials to adjust.



To help you understand the importance of good accounting and the role it must play, here's a very quick history lesson:

Accounting's origins can be traced all the way back to ancient Mesopotamia. By the time of the Roman Empire, the practice was a vital tool in managing such a diverse empire. Taxes needed to be collected and funds expended. Accounting was the tool that was developed and enhanced to allow for some semblance of control where chaos would otherwise reign.



There are many different types of goods and services in any marketplace.

Money is a universal tool that helped civilisations move from the barter system to the market economy. Prior to this time, if somebody wanted food or animals, they had to come up with something of a similar value to exchange it for. That was a big ask!

Money, no matter the currency, was the one thing that now allowed accounting to exist because it was a universal way to represent the activities of the business. Accounting opened up the path for innovation, fine-tuning and the accumulation of wealth.

When money came along, savvy business owners could see the cause and effect of business decisions. The business owners who used this to their advantage were the ones who went on to create massive value and wealth in their industries and societies.

As a small to medium sized business owner, chances are you didn't study accounting, nor did you sign up to start your business because you couldn't wait to pour over numbers! But that doesn't mean you should hand over the understanding of your business finances to your accountant, bookkeeper or business partner.

If you can try to understand what most business owners in your situation don't do, you can make massive gains.

Reading this book will help you harness the power of accounting and start seeing the massive transformation of your business.

It's time to Unfunk Your Business Finances!

**Scott Trevethan**

Business Evangelist

& CEO of Financial Fanatics™

**RECAP**

Accounting as a discipline has been used for thousands of years to give businesses just like yours a competitive advantage. By taking just a few short hours to read this book and follow the action items at the end of each chapter, you will see a massive transformation in your business.



# HOW TO SPEAK ACCOUNTING

# SPEAK

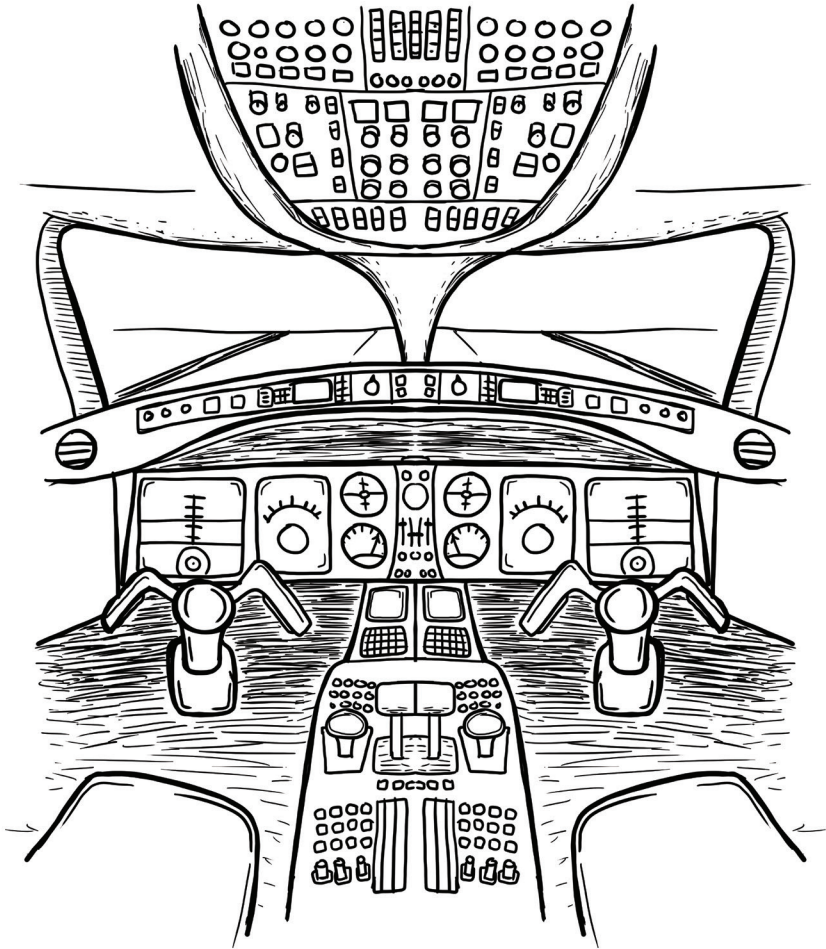
When I was a young boy, flying had a romance about it for me. On almost every flight I took, I was invited to the cockpit to meet the pilot. I was amazed by the sheer volume of dials, gauges and controls that the pilot had to manage in order to take off, fly to a given destination and land safely.

Even in the post 9/11 world, you can still catch the occasional glimpse of the cockpit as you board or exit the plane. It doesn't seem to me to be getting any less complicated. I had thought by now that planes would be kept flying by a simple laptop, but it seems operating an Airbus is a bit more complicated than that.



Let's imagine for a moment you are seated next to a pilot in a small aeroplane. Suddenly, the pilot loses consciousness. **It's up to you to take control and land the plane.**

Assuming you manage to tell the control tower what is happening, they will ask you to first of all look at the altimeter and tell them how high you are. They will then want to know your airspeed and how you are positioned in relation to the artificial horizon and what your current heading was.



Can you just imagine how stressful that would be having them asking you about terms you don't know about and not understanding anything they were telling you?

While things are slightly less dramatic back on the ground, this type of situation is the predicament many business owners find themselves in. They are in the cockpit of their business, making decisions by the seat of their pants. They aren't really sure of the instruments they have to help them and just as importantly, how to read those instruments.

## THE LANGUAGE OF NUMBERS

If you are a café owner, your vocabulary includes terms such as barista, grinder, cappuccino and so on. If you are running a sheet metal fabrication business, you need to know words like adhesive, alternating blanking, mass spectrometer and shimming. It's your industry and business so it makes sense you develop a strong understanding of the terms specific to it.

The great news is there is only one set of accounting terms. These apply across all industries and all countries. It doesn't matter about currency, tax regimes or religion.



**Accounting is like mathematics in this way.** It is impervious to time or any other of the influences that have no doubt changed your business industry many times in the past few thousand years!

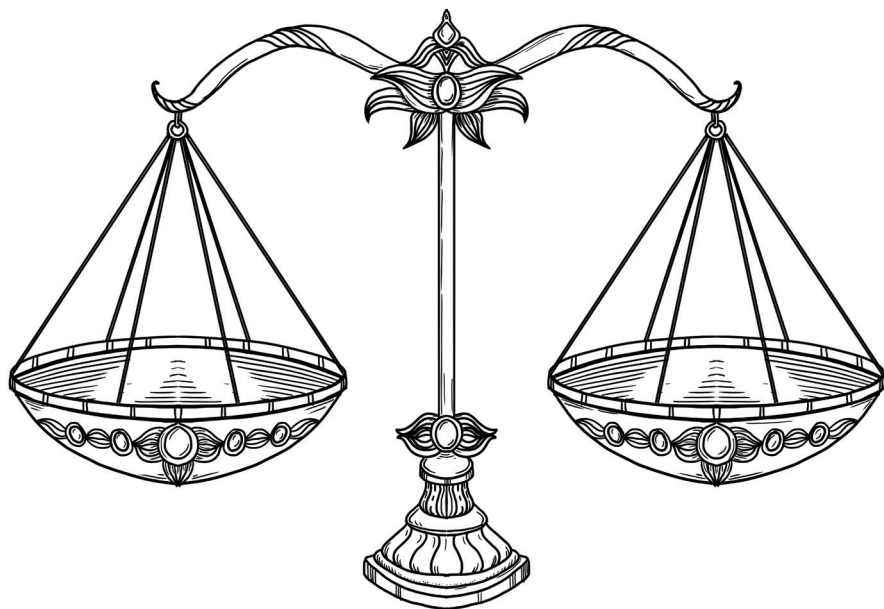
This isn't to say accounting is impervious to the vagaries of time and cultural impacts. There are many policies and rules around the technical edges of accounting that are subject to constant change. But unless you are an accountant, you don't need to concern yourself with those shifting sands. Instead, you just need to know that concepts developed hundreds of years ago are still as relevant today as they were back then. That should bring you a great deal of comfort!

## SINGLE VS DOUBLE ENTRY ACCOUNTING

Before you look at other common accounting terms, here's a basic explainer of why accountants work the way they do.

Until the 6th Century, accounting used what is known as a Single-Entry System. That is, for every business transaction, one single entry was made in the books of the business. The problem with Single-Entry is that it relies on accurately recording and adding all of these entries. Mistakes could easily be made and would be nearly impossible to find later on.

A new system was necessary that could avoid some of the pitfalls of the simple system. And so Double-Entry accounting was created. This meant that for each business transaction, you would have not one but two opposite entries into the books of the business.



The beauty of the double-entry system is that if it is done correctly, it is self-balancing. This means that the correctness of the accounting is immediately apparent because if you forgot to make the second entry or the entry wasn't opposite the first entry, your books would go out of balance. It relies on perfect symmetry, in the same way that scales can always be in perfect balance.

We will discuss how this works in more detail in future chapters, but for now, it is sufficient to know the concept of two entries for every single transaction that occurs in your business. It doesn't matter whether you are accounting for transactions with a quill and ink under candlelight or using the latest Accounting software such as Xero or Quickbooks. The fundamental basis for how accounting works is to record two equal and opposite entries for every business transaction.

What exactly is a business transaction? It is anything that can be represented by money.



The act of employing an assistant in the first place and exchanging their labour for your money is a business transaction.

Making a sale of your goods and service is a transaction. Purchasing the raw materials you need to make your goods and services is a transaction. Renting a factory or an office building is a business transaction. Literally anything that can be represented by dollar value is a business transaction.

## KEY ACCOUNTING TERMS YOU SHOULD KNOW

There are many terms and common phrases when it comes to your accounts. Here are the ones you absolutely must know if you want to do well in business:

**Revenue:** This is the amount of income or receipts your business earns by selling its goods or services.

**Cost of Goods Sold:** This is the cost of producing or purchasing things to sell to your customers. Service businesses might not have an easily measured Cost of Goods Sold.

**Gross Profit:** Revenue minus Cost of Goods Sold is your Gross Profit. It is the amount of money leftover from a sale after you have taken into account all of the costs of producing or acquiring the thing you sold.

**Overheads:** This term applies to the general costs of running your business that cannot be directly related to the cost of making or purchasing the things you sell.

**Net Profit:** Gross Profit minus Net Profit. It is the amount of money leftover from the Gross Profit on a sale, after you have taken into account all of the costs of operating your business.

**Profit and Loss Statement:** The accounting report that contains all of the business transactions relating to selling your goods and services and all the costs associated with running your business.

**Asset:** The items a business owns.

**Liability:** The amount that is owed by the business on the items it owns.

**Equity:** The amount that is owned by the business on the items it owns.

**Balance Sheet:** The accounting report that contains all the items a business owns, the amount it owes on those things and the amount it owns of those things.

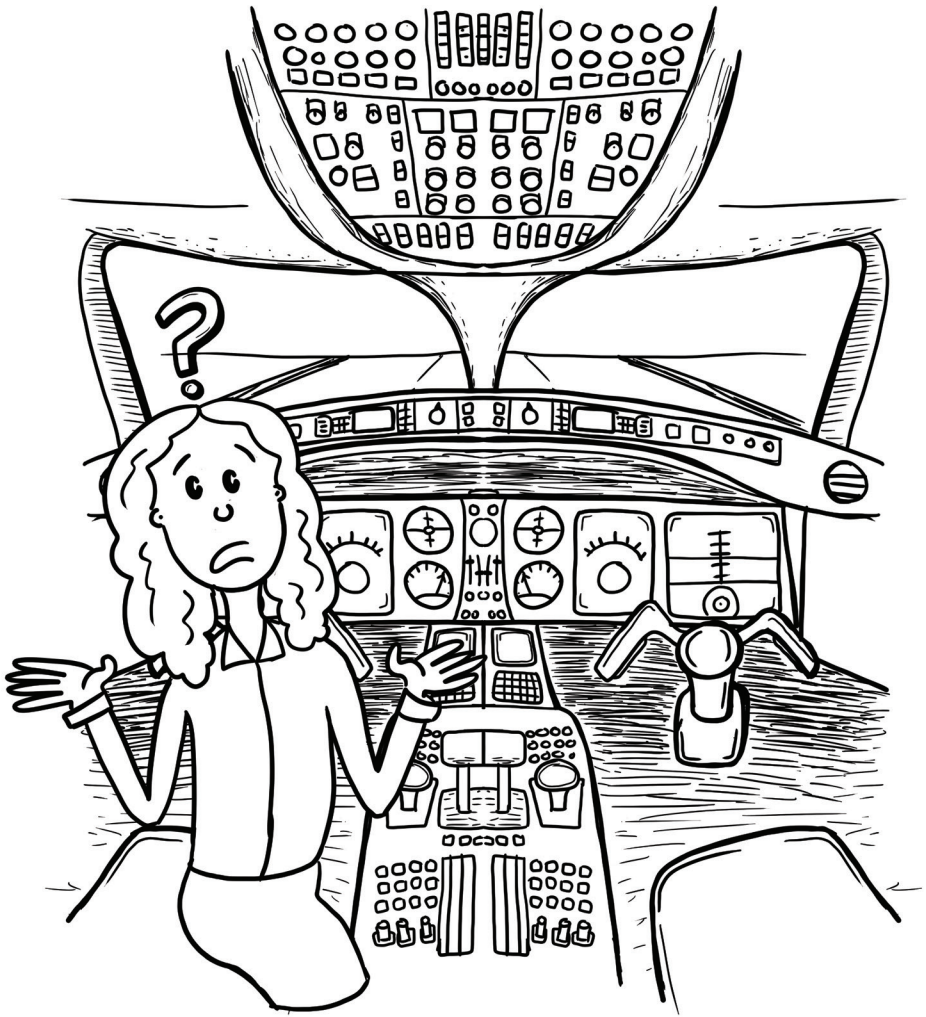
**Cash Flow Statement:** The accounting report that tells a business where its money came from and where it went over a given period of time.

These are the basic terms that will help you learn to understand your business finances. We will go into much more depth about those terms in a later chapter when we discuss the three key reports you need to know about.

## WHY YOU NEED TO UNDERSTAND YOUR ACCOUNTING REPORTS

Let's go back to the pilot's seat for a minute alongside our unconscious pilot and assume you are now aware of the terminology the control tower is asking you about.

The next thing that will help keep you in the air and return you to the ground safely is an understanding of the purpose of each of the key controls. You might know that the Altimeter is the gauge that has a big arrow on it spinning around and around, but if you don't know that the gauge tells you how high you are right now and whether you are going up or down in relation to the ground, you will be in real trouble.



The same can be said about the key gauges or reports that represent your business. Just like the instruments in a cockpit, your financial reports can tell you if you are heading in the right direction, how fast you are going and whether you are going to crash and burn or come in for a nice soft landing!



Once you know the basic terminology and how to read the reports, you can begin to take positive action with the levers that control your unique business with confidence. By this, I meant that you can see the impact that taking certain actions will have.

As a simple test, ask yourself the following questions:

- What impact would lowering my prices have on overall revenue, profitability and cash flow?
- If I spend money on an advertising campaign, what impact will that have and how quickly will I feel the impact?
- Am I going to have enough money to pay my government obligations when they are due or will I need to work out a plan B?

We will go into more detail about all this in later chapters.

### **RECAP**

Understanding the terminology of accounting and the basics of what your accounting reports are saying is a vital skill for any business owner. Similar to flying a plane, it is essential that you know the name and function of the gauges and understand what impact the controls will have on them if you want to avoid a crash.



# STRUCTURING YOUR ACCOUNTING TEAM

I come across businesses all the time in different stages of their evolution. Most of them struggle with the concept of exactly how to go about structuring an accounting team.

When exactly does an accounting team move from a team that costs the business money to a team that makes the business more money and enables them to continue to operate?

The answer depends on what stage you are at in your business. Let's break it down to start-up, small, medium and large businesses.

## START-UP

When you are bootstrapping your fledgling business, it is often tempting to do your own bookkeeping and to hire the cheapest accountant you can find to do your lodgements in a minimal way.

You justify this action based on the notion that if you do the books yourself, you will be closer to the numbers of the business and can keep tighter control over cash. After all, with a startup, you are trying to make your limited resources go as long as possible until you get the traction in your market you need to survive.

Or perhaps you just want to get to the first round of investor finance and every dollar helps.

This is actually a flawed model, for a couple of reasons. Firstly it will take you a lot longer to do the books of your business than it will someone who does this day in and day out. That time can be better spent in either doing what the business needs right now – such as sales, marketing or product development, or even resting up – business is a marathon and you need some time to refresh your mind so you can be more productive.

Secondly, when you do your own books, you are going to be too close to the numbers. If you spend all your time just making sure you get funds correctly allocated to your bank accounts, your bills paid on time and your employees paid when they need to be, human nature states that you won't be able to sit back and look at the big picture. Your job as a business owner is to be able to read and understand the reports, not to put all your time and effort into producing them.

The number one piece of advice for start-ups is to engage a good accountant before you even commence your venture. Yes, this professional will cost you some of your seed capital but they will ensure you are set up correctly so you have no issues once your business is a success. By skipping this step, you are assuming you will be able to fix all the small errors once you get your business off the ground. But believe me, things have a way of snowballing and small problems become large ones which are hard to fix.

Sometimes accountants can be seen as too negative when it comes to starting new business ventures. Accountants are conservative by nature and that means they wouldn't take the risks that you are prepared to take given the chance of success and the dangers along the way.

However, think of your accountant as your own personal Jiminy Cricket. It can be very helpful to have an advisor in your corner who sets you up correctly and maximises your chances for success while taking some of the worry of starting and running your business away.

Some accountants specialise in start-ups but you need to ensure your accountant can be with you for the long run. It is much better to be with an accountant who knows and cares about your financial success than swapping accountants every few years to save money or because you no longer fit their client profile.



**You also need a good bookkeeper.**

This resource will make your accountant's job a lot easier because they will be able to do the setup tasks for a lot less cost, giving your accountant more robust numbers to work with.

Bookkeepers can usually scale their offering to you based on the amount of time it takes to process transactions. This means a good bookkeeper does not need to cost a lot but can save you a lot in accounting fees while providing you with essential information about how you are travelling in the critical start-up period.

## SMALL BUSINESS: UP TO FIVE EMPLOYEES

This section applies when you are up and running and getting other people involved to help grow the business. You won't need full-time accounting support but you will require the services of a good external accountant and bookkeeper.



Your accountant for this business will be able to assist you with budgets. Your bookkeeper will be able to input those budgets into your system in order to produce meaningful reports. You will be spending money on both your accounting and bookkeeping but the value this brings will far surpass the additional cost. One thing to note is that it's all too easy to not see the value of your accountant and to instead focus on the cost. Make sure you understand what your team does and how much money they save you by doing it. Their value will become a lot clearer.

As a small business owner, you need to meet with your accountant at least three times a year. The first time should be when you first engage them. They will need them to review your business plan and assist you with cash flow forecasting. They will share advice on putting in place Key Performance Indicators and monitoring such as a dashboard (more on dashboards soon).

Don't worry if you don't have a formal business plan to show your accountant. He or she will be able to ask you enough key questions to get a sense of what it is you are doing and what you plan to add value to the market is.

Make sure you take notes as your accountant will probably give you words of advice. Write everything up into a business plan document so you can review/clarify advice along the way.

Your next meeting will be around two months before the end of the financial year. This meeting is about tax and you are looking for strategies that will save you tax, help your cash flow or preferably both.

Your final meeting should be just after the conclusion of the financial year and will involve a discussion on the performance of the business and how that impacts future plans. This is a more detailed meeting to ensure you have done your compliance needs for the year and to check you have a good base for the coming year.

Ideally, you should start to get your accountant involved in your personal finances as well. While your accountant may not be a licensed financial planner, you need to get some planning in place to boost your personal financial wealth so you can protect your future.

Decisions like how much money the business can afford to pay you and what you should be doing with that money can be incorporated into your tax and strategic planning meeting.

## MEDIUM BUSINESS: UP TO 25 EMPLOYEES



Congratulations! You have a bigger business now, with many more moving parts. You will need an on-staff finance team to assist you with making sure your business finances are on track. You will also need much more engagement from your accountant or their team.



First of all, at this size, it is unlikely you will outsource your bookkeeping/payroll any longer. You will have a full time dedicated internal accountant on your team who will ensure you collect what is owed to you, pay your bills on time and manage your employee payroll so they keep turning up to work! For a business your size, this is a full-time job. You will need to work more closely with your accountant in order to get some bigger projects/business improvement plans in motion.

At this level, it is ideal that your accountant is very engaged in your business (see next chapter on being an A-Class client). You will want them to be invested in your continued success and that means regular contact at different levels within their firm. Ideally, the partner or senior principal will be looking after your high-level concerns. Strategic direction, structures, acquisitions, mergers or divestments would be the kind of discussions you are having at that level. You would also have the use of a senior manager. This person's job is to ensure your compliance is maintained up to date, that your accounting records are correct and that your cash flow is well managed.



The way that might look to you is that you have a scheduled strategic meeting and a tax planning meeting with the principal once per year and then quarterly or even monthly meetings with your senior manager.

You would then call or email the principal whenever you had a big strategic issue to deal with. If you didn't have three or four of those additional calls to your accountant per year, you must have a very stable business in a very stable environment! Just make sure you aren't playing it too safe as you may be missing opportunities.

## LARGER BUSINESS: OVER 25 EMPLOYEES

Once you are at this level, it is likely you have an internal accounting team. This team would typically break down the accounting functions into receiving money and spending money.

You may have a payroll officer if the payroll is large enough and complex enough to justify one. You will certainly have a manager over this team to ensure that everything flows smoothly. This person is typically called a Financial Controller or a Chief Financial Officer (CFO). These two roles do the same thing but on a different scale.



The Financial Controller or CFO will have the ability to internalise the strategic planning and implementation that you had previously been outsourcing to your accountant.

This gives your business added capability as you no longer need to rely on your external accountant for many of the answers that you needed in the past.

It doesn't mean you have no further need for your external accountant. You will likely need to outsource your tax planning and more complex tax issues to your accountant and you may even have auditing requirements and complex reporting to be assisted in as well. At this level, it is likely that you have a board of management and it would be ideal to have your external accountant on that board, even if just from a taxation perspective because at this level, typically the bigger the business the more complex the issues are.

You should now know what your accounting team will look like at each phase of business. There's no need to panic and bring people on board who you don't need when you're small. However, it's not a good idea to skimp on accounting professionals as your business grows.

Evaluate what you have now in terms of financial support and think about a planned structure to maximise the value you get from other people helping you get your finances in order.

The next chapter will detail how you can go about extracting that maximum value out of your accountant.

### RECAP

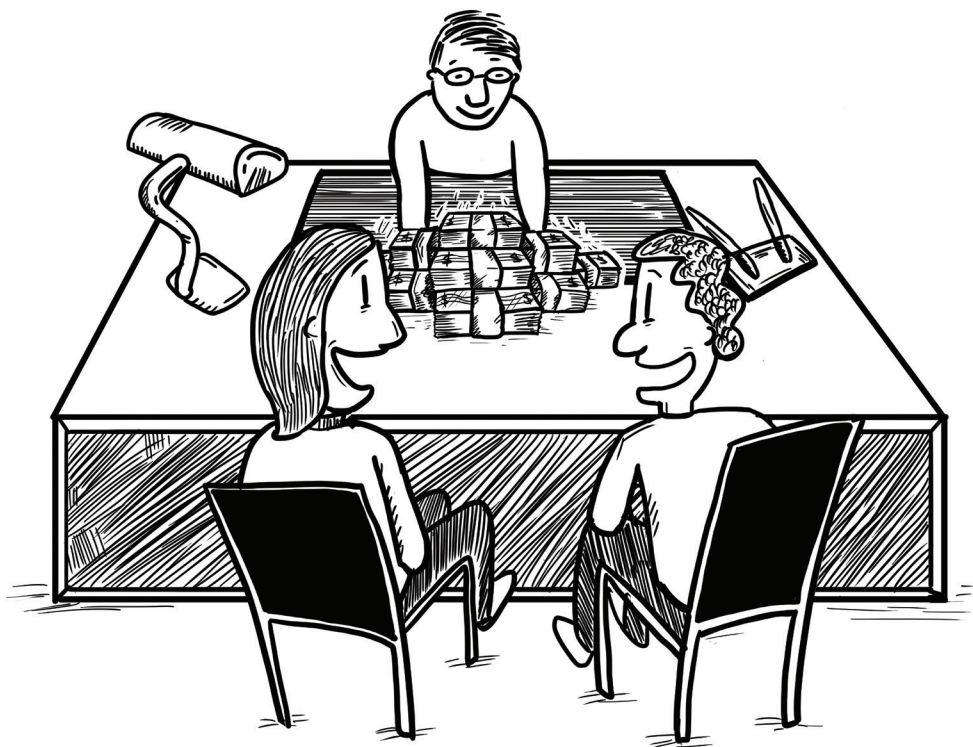
The size and functionality of the accounting team supporting you will depend on which stage you are up to in your business journey. Make sure you are getting the help you need for the stage of your business so you can manage your business growth in the best way.

**WHERE ARE YOU ON YOUR BUSINESS JOURNEY? WHAT TEAM DO YOU HAVE IN PLACE TO SUPPORT YOUR GROWTH RIGHT NOW? TALK TO YOUR ACCOUNTANT OR BOOKKEEPER TO SEE WHAT LEVEL OF SUPPORT IS RIGHT FOR YOU.**



# HOW TO HELP YOUR ACCOUNTANT MAKE YOU RICH!

Accountants are great at working with numbers but it's a sad fact of life that most accountants are not that great at helping their clients become rich and successful.



That doesn't mean they don't want to. In fact, it's great business for your accountant to have a successful client who attributes that success to the person who helps them with their finances.

As a business owner, you need to know how to tap into your accountant's potential for helping you succeed in your business. It isn't hard and it's highly likely your accountant already has helped some or even many of his clients to succeed in business and become wealthier in the process. It's just you haven't discovered the secret of how to tap into that advice yourself.

If you really want to make the most of your accountant, first of all, it's important to know how accountants classify their business clients – yep you will have one of these tags after your name on the accountant's client list:

## A-CLASS

Those clients who value their accountant's time, always pay on time or in advance and never question the bill are A-class. They will actively seek advice and act on that advice. They will refer other businesses of a similar size and classification to their accountant.

A-class clients are the ones accountants get out of bed for in the morning. The reason is simple. You give value and meaning to your accountant if you are operating in this category. He or she will give you time, energy and the value of his or her experience across all aspects of your business. They will save you tax, come up with innovative ways to structure your business and help you evaluate your investments. They will even bring investment opportunities to you from other clients or within their own social group.

Want to get in on the ground floor of a new property development or innovative opportunity? Be an A-class client.

## B-CLASS

Those clients who value their accountant's time, pay on time or in advance and sometimes seek advice or at least are open to advice fall into the B-class category. They will typically engage their accountant for at least a tax planning meeting once per year.

B-class clients often have some kind of block preventing them from stepping up to A-class. Typically it is around not seeing value for the fees, so their accountant feels they need to prove their value constantly. Your accountant doesn't relish having to prove their worth all the time and so you won't get the benefit of the 'proactive' advice or investment opportunities that come their way.

In case you're wondering, or if you recognise yourself as a B-class client, the fees you pay go to paying the overheads of the accounting business.



This includes your accountant, their staff and the tools they use to help you make the most of every dollar your business earns.

A-class clients understand that for every dollar they 'invest' in their accounting fees, they receive a very large return. Your accountant isn't greedy. They might charge you a high fee, but the return thanks to investment opportunities, tax savings or business advice should be worth five times what it costs.

By way of an example, an accountant friend of mine related a story of how a client of his came to him with a \$2M tax debt on the verge of bankruptcy. He offered to fix their issue for a \$50k fee. The client recognised that they needed to trust my friend and so agreed, however reluctantly. My friend made a phone call to the tax authority and offered them \$250k to settle the whole debt. The tax authority agreed, saving my friend's client \$1.7M (not to mention financial ruin) for an investment of just \$50k.

If you are a B-class client, you aren't the accountant's reason for being in business in the first place. They will help you keep your business running and profitable but they won't be focused on making you rich. You'll get help paying less tax, but you won't be thanking them too much in your retirement speech!

## C-CLASS

Now we are getting to those clients who can cause more trouble for the accountant than they contribute in terms of fees.

With C-class clients, bills are often questioned. Advice is only sought when absolutely needed, and even then there is a reluctance to pay for that advice (indicating you don't value it). Your business still contributes fee income for the accountant, even if it is only at year-end but it is highly unlikely to get any specific proactive advice or investment opportunities.

If you're C-class, you will frequently find yourself with new client managers looking after your business and you will rarely have access to the firm's accounting principal or partner.



## D-CLASS

This is the worst type of business client. D-classers are miserly, always questioning the value of what they get. They will attempt to cut corners in an effort to cut accounting fees.

They make it clear they are only a client because they have to be and not because they see any value in what their accountant does or says. They will be well behind in their tax obligations and will generally think they are victims in the world.

D-class clients can do very well financially when the times are good, generating large tax bills in the process, but quickly fall into cash flow issues when times are less than ideal. If you are a D-class client, you will likely find yourself moving to E-class or being referred to a bankruptcy specialist.

## E-CLASS

E-class clients no longer fit the business model of the accountant. E stands for Exit and you may find yourself either bundled with other clients in this class and sold to another accountant. Alternatively, you will receive a letter advising you are no longer a client of the firm and they wish you all the best in the future.

This may not be your fault at all. It might be the business model of the accountant changed to only work within a set industry or size of business. However, in my experience, it is most likely business owners who are classified as C, D or E who are likely to find themselves 'sacked' as a client.

## WHAT CLASS ARE YOU IN?

Hopefully by now you have resolved that you want a relationship with your accountant that adds a lot more value than it costs, but you realise that this will cost you more in the short term.

For a great relationship and A-class status, your first step is having an open and honest dialogue (they shouldn't charge for this meeting) to see whether this is something your accountant can accommodate or not. Please be aware that most accountants have trouble saying no to any client. You will need to use your own gut feel as to whether your accountant will foster the sort of relationship you need.



I suggest you start by asking your accountant whether they have a classification system, what classification you are and why.

It might make them a bit uncomfortable but if you can assure them that you only want to make your relationship more valuable to all parties I'm sure they will be impressed!

The next thing to do to help your accountant make you rich is to engage them far more often. This professional will likely have a wealth of experience in not only your industry but many other industries. They are uniquely placed to help you with lessons from other clients. But you have to know what to ask and when to ask it.

## MAKING THE MOST OF YOUR ACCOUNTANT

Many accountants have now moved to fixed-fee billing but some still use what is known as time-based billing. This is where for every minute your accountant spends with you or on the phone or answering your emails, you will be charged, usually in 6-minute intervals (there are 10 x 6 min increments in each hour). One unit of 6 minutes can cost \$30 or more and so clients can end up with large and unpredictable invoices if there was a flurry of activity during any particular month.

Under this time billing system, it's not surprising that clients developed an aversion to asking their accountants for anything. Checking in became an expensive procedure so clients forwent that vital part of the relationship. This actually worked against the client's best interests as it discouraged them from seeking the help they needed when they needed it.

Fixed fee billing doesn't seek to charge clients less, it's just that there is an allowance made for phone calls, emails and meetings so these don't need to be charged separately. This is a major psychological shift and means you no longer need to worry about getting your accountant's input into key decisions.

Now you have a fixed fee and you know you can call your accountant when you need them, keep yourself as A-class by being mindful of their busy day. There does need to be a personal connection on some level but phoning to speak about the football will downgrade you as a client. Keep things concise and business-focused as much as you can.

## WHAT SHOULD YOUR ACCOUNTANT HELP YOU WITH?

No matter what size your business is, your accountant's basic function is to help you balance your books, file your annual tax return and make sure your business isn't spending more than it can earn. They should also talk to you about elements like budget and forecasting so you can create a plan for the future.

From here, there are plenty of other things your accountant can help with. What you choose to work together on depends on the size of your business.

When you work with an accountant, at the top of the tree are any high-level, strategic items such as buying a business, selling a business, merging your business, entering a new market/country or restructuring your business.

The next item down would be low level strategic items such as a new marketing campaign, new products or services and perhaps even buying some new equipment.

Then there are high level operational questions such as strategic hires, changes to operations, moving premises and the purchase of capital equipment.

Low level operational questions include pay reviews, supplier arrangements, changes in trading terms and lease reviews.

Your accountant doesn't have to give you permission to do these things. What they do is provide an outside perspective and show you what the outcome of your plans are likely to be. By involving your accountant into the big and sometimes just operational issues facing your business, you are opening up a line of communication which empowers them to give you the kind of advice that will make all the difference in your business and personal financial situation.

## THE HOLY GRAIL: PROACTIVE ADVICE

Clients want it and accountants want to give it but just what is proactive advice?



This type of advice is something your accountant would give you without prompting in any way. It is specific to your needs and involves an opportunity to make more money in your business or to save money in your business.

Accountants are presented with business sale opportunities all the time. They get advice from good people looking for new opportunities. They get finance deals presented to them as well. On top of that, any time a client does something innovative that works for them, their accountant can take a mental note and, subject to privacy, can advise other clients to take advantage of that as well.

Unfortunately, it doesn't tend to work that way for many clients and accountants because your accountant has not been trained to look out for opportunities to make you more money. You need to value what your accountant does for you and then look to make that relationship really pay off for you in the long run.

Real personal wealth is not the same as business wealth. It might be fun to invest all your surplus cash and profits back into the business but it would be prudent to take some of that off the table or at least evaluate where you will receive the best return on your investment. Your accountant should be across your personal wealth situation as well as your business and be working towards your vision for both—so don't keep your them guessing!

A word of warning. Don't play games with your accountant. Don't lie or hide any details from them. Some business owners have a belief that you should never tell anyone the whole situation. This is a dangerous viewpoint. Your accountant will know you are withholding the full truth from them and you will not receive proactive advice. Always disclose everything to allow your accountant to help get the wealth you desire.

Remember, your accountant is here to help. Business owners can be secretive about money but think of this professional like a doctor for your bank account. They need to know what they are working with so they can get the best results. They are not judging you because you didn't file your BAS last quarter or because you have a few more outstanding payments than you would like. Sometimes you just have to take a deep breath and explain what's going on so your accountant can work with you to find the right solution.

### RECAP

Your accountant can help you and your business achieve financial success but you need to unlock that help. Understand how your accountant views you as a client, value them, find out where they can add value and then let them look after your interests without your prompting.

**INVITE YOUR ACCOUNTANT OUT TO LUNCH!** Have a full and frank discussion on how they rank or classify you and what you can do to achieve 'A' status. Make a commitment to your accountant to really value their advice.





# THREE MUST-HAVE REPORTS FOR YOUR BUSINESS

This next section will teach you the basics of what each major financial report does and how you can read it effectively.

The next chapter goes into more detail about how to really understand how the ‘controls’ of your business aeroplane can be moved so you can leverage the information you have to keep on cruising at altitude.

In the first chapter of this book, we discussed the reasons why you need to understand the language of accounting so you can understand the dashboard and you know whether you can stay in the air.



There are many different accounting reports that you can run for your business off most of the major accounting packages.

However, no matter where on this planet you are based, what your business is or what the current economic cycle is in, there are three main reports that you need to know.

These are:

- 1) The Balance Sheet
- 2) The Profit and Loss
- 3) The Cash Flow statement

We need to go wide and then somewhat deep with each one. Please don't be put off by the technical terms. By the end of this chapter you will be reading reports like a pro!

### CASE STUDY

*To illustrate the use of these three reports, we will use the case study of Sam's Plumbing.*

Sam sells a service, her plumbing expertise, to fix or install things such as taps and hot water services. She also sells plumbing fixtures and other items to her customers for a profit.

Sam finished first in her trade class and built up a really strong reputation for quality work and reliability in her local community over the past few years. She has recently put on a full time apprentice, Stash, who is a keen student, even if Sam thinks he spends too much time playing video games rather than studying the finer points of PVC piping!

## REPORT #1: THE BALANCE SHEET

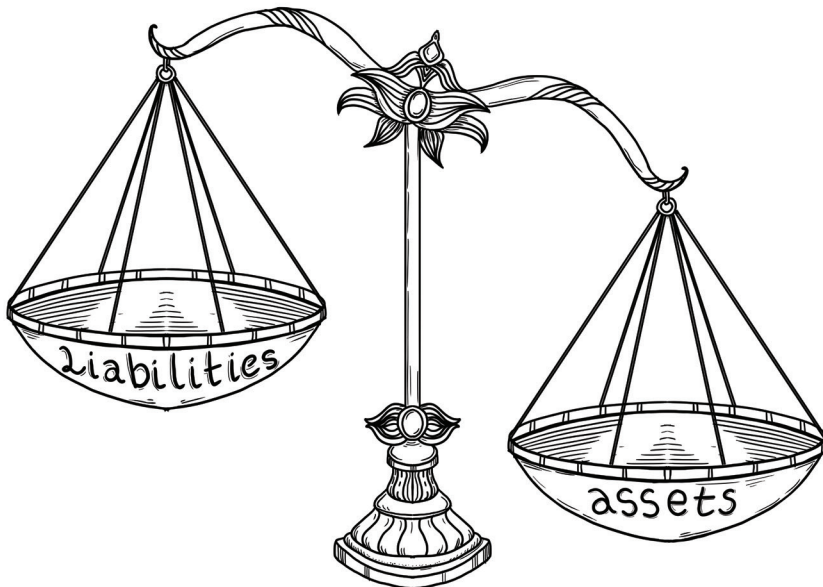
The Balance Sheet is a representation of three things about the business at a specific point in time. It could be yesterday, last week, last month or last financial year. Your Balance Sheet gives you a snapshot of the business at that point in time.

The Balance Sheet contains the following information:

- Things the business owns;
- Money the business owes on those things; and
- Money the business owns on those things.

I talked earlier about the beauty of the invention of double-entry accounting. This is truly and visually reflected on the balance sheet because of the following equation:

Things that the business owns = Money that the business owes on those things + Money that the business owns on those things



**That is why it is called a Balance Sheet; it is always in perfect balance!**

A Balance Sheet is so-called because the total amount of Assets is always equal to the Total of Liabilities and Equity. It can also be called a Statement of Financial Position because it shows your business's financial position too.

The things the business owns, in accountant speak, are called 'Assets'.

Money that is owed is referred to as 'Liabilities'.

Money that is owned is called 'Equity'.

I will briefly address each one in term, although textbooks could be and are written on them if you want some further study! (hint - you don't need to).

### ASSETS

Often managers will say something like "Jo is an asset to this company". Technically speaking, that is incorrect.

Jo is not an asset because unless Jo is owned by the company i.e. a slave. Jo is an employee. But the term is used to imply that Jo was a valuable tool that business uses to make money.

Here's some more detail:

The job of the business owner is to turn Assets into Sales, those Sales into Profits and those Profits into Cash.

An Asset is any 'thing' that the business has that will help it do what it does to generate sales. Business assets can include cash at bank, money owed by customers, inventory or stock on hand, machinery and equipment, land and buildings and motor vehicles.

Assets are verifiable at a point in time. Verifiable means we could show you evidence of ownership and value that make up those numbers on the balance sheet. This is important as you will see that not every report is made up of these verifiable numbers.

### ASSETS EXAMPLE: SAM'S PLUMBING

*Sam has a plumbing van she uses in her business that she purchased for \$50,000 when she decided to set out on her own. She has \$10,000 cash in her trading account and \$45,000 cash put away for future purchases. She has tools and equipment that she paid \$25,000 for.*

*The Wilson, Evan and Sharpe families owe Sam a total of \$4,500 for plumbing services last fortnight. She also keeps a couple of Hot Water Units in her garage for emergency use that she paid \$1,200 each for. Apart from that, she has spent \$7,500 on bits and pieces in her van that she uses on her plumbing jobs.*

<b><i>Sam's Plumbing Assets are:</i></b>	
<i>Cash at Bank</i>	<i>\$10,000</i>
<i>Cash on Investment</i>	<i>\$45,000</i>
<i>Cash Owning from Customers</i>	<i>\$4,500</i>
<i>Inventory (2 x Hot Water + Bits)</i>	<i>\$9,900 (2 x \$1,200 = \$2,400 + \$7,500 = \$9,900)</i>
<i>Tools and Equipment</i>	<i>\$25,000</i>
<i>Van</i>	<i>\$50,000</i>
<b><i>Total Assets</i></b>	<b><i>\$144,400</i></b>

### LIABILITIES

Money owed by the business is referred to as liabilities.

You might have even heard the same managers say while Jo was an asset, Peter was beginning to be a liability. Again this is wrong. Peter's performance was costing the business in sales or lost productivity but he isn't a bill that the business will have to pay.

A liability is money that the business owes. Liabilities of the business include overdrafts and bank bills, money owed to suppliers, lease payments due on assets as well as taxes due.

These liabilities are also verifiable at a point in time. You can see the contract or agreement that corresponds with the amount on the balance sheet.

LIABILITIES EXAMPLE: SAM'S PLUMBING

Sam borrowed \$25,000 from her parents when she first started her business and she has been diligently paying that off each month so it's down to \$15,000 now. She has an excellent trading history so her main supplier lets her pay 14 days after she takes the goods. She currently owes them \$4,250 for things she has purchased for her business. She owes the government \$12,800 for last quarter's trading as well. Sam also uses a credit card for things like fuel and that currently has a balance of \$350 owing.

Sam's Plumbing Total Liabilities	
Credit Card	\$350
Trade Creditors	\$4,250
Taxes Payable	\$12,800
Borrowing from Parents	\$25,000
Total Liabilities	\$42,400

EQUITY

If Assets are things that the business owns and Liabilities are money that the business owes, then Equity is the difference. It is really that part of the businesses assets that are owned.



If Assets are things that the business owns and Liabilities are money that the business owes, then Equity is the difference.

When you think about Equity in a home, it is the difference between what the home is worth and what you still owe the bank for it. If you sold the home, you would need to pay back the loan and you would be left with the equity.

The Equity of a business can include money the investors have put into the business as share capital, current year profits and what hasn't been distributed to the owners from past years profits, which is called retained (get it, not given out but retained) earnings. If a business is said to reinvest its earnings into the business, this really just means it is retaining part or all of its profits for that year. (Which allows for a correspondingly higher bank balance).

**EQUITY EXAMPLE: SAM'S PLUMBING**

*When Sam started the business, she wanted to buy a van and tools for \$75,000. She had savings and her grandmother had left her \$50,000 to invest in her business. The total was still short by \$25,000, which she borrowed from her parents. She 'pays' herself from her profits but likes to keep a bit left over as she hopes to buy Stash a van of his own when he graduates from trade school.*

<b><i>Sam's Plumbing Total Equity</i></b>	
<i>Initial Investment</i>	<i>\$50,000</i>
<i>Prior Year Profits</i>	<i>\$23,600 (the amount not yet distributed to Sam)</i>
<i>Current year Profits</i>	<i>\$28,000</i>
<b><i>Total Equity</i></b>	<b><i>\$101,600</i></b>

# ONE MORE DETAIL

There is one more step to be aware of if you want to get the most from your interactions with your accountant.

Assets are divided between Current and Non-Current Assets. This is going to become important when we look at the ratios that you need to be aware of in future chapters.

## CURRENT ASSETS

A Current Asset is one in which the economic benefit to the company is expected to be consumed within a 12 month period. These assets are cash or things that are able to be converted to cash. Think, your operating bank account, accounts receivable and stock on hand (including work you have in progress but not yet finished if that is applicable to your business).

These are the assets that either are cash or can be turned into cash quite easily, such as by collecting the amounts owed to the company or by selling the stock you have on hand and then collecting those amounts.

## CURRENT ASSET EXAMPLE: SAM'S PLUMBING

*In Sam's Plumbing example we saw that Sam had a total of \$144,400 in Assets. Of that amount, the following would be considered to be Current Assets because they are cash or will be converted to cash in the next 12 months:*

<b>Sam's Plumbing Current Assets are:</b>	
Cash at Bank	\$10,000
Cash on Investment	\$45,000
Cash Owing from Customers	\$4,500
Inventory (2 x Hot Water + Bits)	\$9,900
<b>Total Current Assets</b>	<b>\$69,400</b>



## NON-CURRENT ASSETS

Non-Current Assets are those things that the business owns that give an economic benefit to the business over more than one year. When it comes to these assets, we expect them to enable us to produce our products and services for over a year and in some cases for many years to come. Think of the equipment used in the business; cars and trucks that help transport people and goods around, computer equipment and also even land and buildings that our business may operate out of that the business owns and not simply rents.

### NON-CURRENT ASSET: SAM'S PLUMBING

*The things Sam has that will last more than one year are her van and also her tools. When Sam bought those significant items for her business, she expected them to last well into the future so that she could keep on earning a return on them. She didn't expect to recoup the cost of her van or her tools in a single year.*

***This is how this looks on her Balance Sheet:***

<i>Tools and Equipment</i>	<i>\$25,000</i>
<i>Van</i>	<i>\$50,000</i>
<b><i>Total Non-Current Assets</i></b>	<b><i>\$75,000</i></b>

## DEPRECIATION

The lesson on Fixed Assets is that you don't expect to recoup the entire cost of the thing you purchased within 12 months. As the economic benefit, i.e. the contribution to sales and profits of the business, goes for more than one year, we need to allocate the cost of that asset for however long the asset is expected to contribute to the business.

This cost allocation is called Depreciation and the total Depreciation is represented under each asset on the balance sheet so you can determine how much economic benefit each asset has left.

### DEPRECIATION: SAM'S PLUMBING

*When Sam purchased her van and her tools two years ago, she expected to get eight years out of her van and five years out of her tools. She knew that up until the time she replaced both of those things, they would keep on doing their job in the same way as when she purchased them. The van would still drive her around and the tools would still unblock pipes etc. In this case, we can simply apportion the annual cost of the van and tools based on what Sam expects them to be:*

***Van - Cost \$50,000 / 8 years = \$6,250 per year***

***Tools - Cost \$25,000 / 5 years = \$5,000 per year***

*The above costs per year are then charged against the profit of that year as 'Depreciation'. The cumulative depreciation of each item reduces the balance of that item in the Balance Sheet as follows:*

<i>Van</i>	<i>\$50,000</i>
<i>Less Accumulated Depreciation</i>	<i>(\$12,500) - nb this is for the two years</i>
<i>Tools</i>	<i>\$25,000</i>
<i>Less Accumulated Depreciation</i>	<i>(\$10,000) - two years</i>
<b><i>Total Non-Current Assets</i></b>	<b><i>\$52,500</i></b>

*You can see that the value of Fixed Assets declines over time as their economic benefit (or use to the business) declines. By the time we get to the end of the fifth year, the tools will have been completely used up and charged to the profit and loss and the same by the eighth year of the van.*

It's worth noting that the value on the balance sheet is not attempting to approximate the value of the items in real life. We all know that most cars lose value much quicker at the beginning of their life compared to their end. We are simply allocating the cost of the asset over its life, based on the consumption of the benefits by the business.

Unfortunately, you can't look at the total value of assets on a balance sheet and expect that to be the exact value of those assets to either replace or to sell. Your accountant is apportioning the cost of an asset over its life rather than looking to assign a specific dollar value.

## LIABILITIES

Liabilities are also divided into two categories - Current and Noncurrent. Unlike Assets, this has nothing to do with economic benefits and everything to do with when you need to pay.

### CURRENT LIABILITIES

The term Current Liabilities refers to money the business owes for various things that are expected to be paid for within a period of 12 months. This includes overdrafts for the business, credit cards, money you owe suppliers, tax liabilities and short term loans.

Liabilities are much simpler to understand than Assets as the Balance Sheet just represents exactly what the business will need to pay in a period of less than 12 months. This may not be that helpful in working out cash flow for the next week or month as 12 months is the timeframe used to switch between current and Non-Current but it does give us some good information we can use.

### CURRENT LIABILITIES: SAM'S PLUMBING

*You would expect Sam to pay off the balance of her credit card and pay her suppliers within a reasonable period, and certainly within a 12 month period. She will also need to pay her taxes owing in that period or she will risk the Government closing her business down!*

*Of course, the balance of Sam's credit card, trade creditors and taxes payable will vary all the time. Remember a Balance Sheet is a snapshot at a point in time. So as at the day of the balance sheet being prepared, that was the balance of liabilities that were expected to be paid within 12 months.*

<b><i>Sam's Plumbing Current Liabilities</i></b>	
<i>Credit Card</i>	<i>\$350</i>
<i>Trade Creditors</i>	<i>\$4,250</i>
<i>Taxes Payable</i>	<i>\$12,800</i>
<b><i>Total Current Liabilities</i></b>	<b><i>\$17,400</i></b>

NON-CURRENT LIABILITIES

Non-Current refers to the money that the business will need to pay over periods of more than one year. Think longer-term loans that are used for more structural purchases. Bank loans, bonds and sometimes shareholders or owners loans are common to find in Non-Current Liabilities.

The important thing to remember here is that the business won't need to pay them off within the next 12 months. It's like the difference between a supplier debt and a home loan.

NON-CURRENT LIABILITIES: SAM'S PLUMBING

*Sam doesn't need to pay her parents off all at once or even within a single year. So the whole of the loan is classified as Non-Current, even if she pays a bit of it off.*

<i>Sam's Plumbing Non-Current Liabilities</i>	
<i>Borrowing from Parents</i>	<i>\$25,000</i>
<i>Total Non-Current Liabilities</i>	<i>\$25,000</i>



A Liability is what the business owes for goods and services, money borrowed or taxes.

## EQUITY

Unlike Assets and Liabilities, we don't divide Equity into Current and NonCurrent. Equity is just the value of the money the owners have put into the business and the net amount of profits that the owners have not taken out of the business.

### **Key information to take note of:**

Assets minus Liabilities = Net Assets = What your business owns of the Assets.

We will go into more detail on how to use the report in a later chapter.

*Let's put everything together and show how Sam's Plumbing would be represented as a single Financial Report.*

### ***Sam's Plumbing:***

#### ***Balance Sheet as at 30th June 2020***

### **ASSETS**

<b><i>Current Assets</i></b>	
<i>Cash at Bank</i>	<i>\$10,000</i>
<i>Cash on Investment</i>	<i>\$45,000</i>
<i>Cash Owing from Customers</i>	<i>\$4,500</i>
<i>Inventory (2 x Hot Water + Bits)</i>	<i>\$9,900</i>
<b><i>Total Current Assets</i></b>	<b><i>\$69,400</i></b>

<b><i>Non-Current Assets</i></b>	
<i>Van</i>	<i>\$50,000</i>
<i>Less Accumulated Depreciation</i>	<i>(\$12,500) - nb this is for the 2 years</i>
<i>Tools</i>	<i>\$25,000</i>
<i>Less Accumulated Depreciation</i>	<i>(\$10,000) - 2 years</i>
<i>Total Non-Current Assets</i>	<i>\$52,500</i>
<b><i>Total Assets</i></b>	<b><i>\$121,900</i></b>

**LIABILITIES**

<b><i>Current Liabilities</i></b>	
<i>Credit Card</i>	\$350
<i>Trade Creditors</i>	\$4,250
<i>Taxes Payable</i>	\$12,800
<b><i>Total Current Liabilities:</i></b>	<b><i>\$17,400</i></b>

**LIABILITIES**

<b><i>Non-Current Liabilities</i></b>	
<i>Borrowing from Parents</i>	\$25,000
<b><i>Total Non-Current Liabilities:</i></b>	<b><i>\$25,000</i></b>
<b><i>Total Liabilities</i></b>	<b><i>\$42,400</i></b>
<b><i>NET ASSETS</i></b>	<b><i>\$79,500 (Total Assets less Total Liabilities)</i></b>

**EQUITY**

<i>Initial Investment</i>	\$50,000
<i>Prior Year Profits</i>	\$12,350
<i>Current year Profits</i>	\$17,150
<b><i>Total Equity</i></b>	<b><i>\$79,500</i></b>

*From the above report, you can see that the Net Assets amount is equal to the Total Equity. Another way of saying this that the Net Assets are in Balance with the Total Equity, which is where we get the name Balance Sheet from.*



From the above report, you can see that the Net Assets amount is equal to the Total Equity.



The things the business has are called Assets and they are split between Current (to be used within 12 months) and Non-Current.

### RECAP

The Balance Sheet records the things that a business has and the money that it owes as a snapshot at a point in time.

The things the business has are called Assets and they are split between Current (to be used within 12 months) and Non-Current.

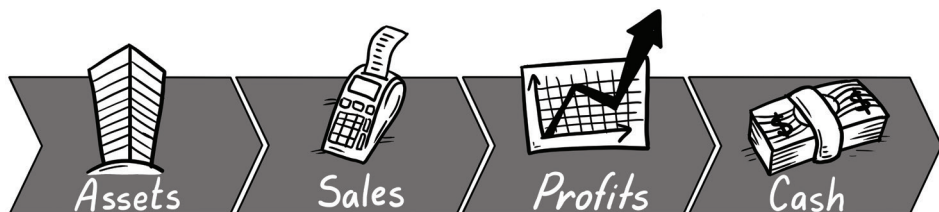
The money the business owes is called Liabilities and they are split between Current (to be paid within 12 months) and Non-Current.

The difference between Assets and Liabilities is what the business 'owns' and that is called Equity.

**TAKE A LOOK AT YOUR OWN BUSINESS BALANCE SHEET BEFORE YOU GO ANY FURTHER.** Make sure you understand all of the items in it and that it makes sense to you. If in doubt, your accountant should be happy to give you advice.

## REPORT #2: THE PROFIT & LOSS OR INCOME STATEMENT

The Profit & Loss (also known as your Income Statement) is a representation of the total value of revenues and expenses over a given period.



Unlike the Balance Sheet, it does not represent a snapshot at a point in time, but rather the cumulative amount of activity from a point in time to another point in time. It could be from the start of last year to the end of last month, or last quarter or last month.

There are three main categories within the Profit and Loss statement. They are:

- 1) Revenue
- 2) Cost of Goods (or Services Sold)
- 3) Overheads

An understanding of these three items will put you well on the path to understanding this particular report.

### REVENUE

Revenue is simply what that business earned over the period. It is typically the sale of goods or services but it could also be rent received or dividends received as well. Focus on the main product or service of your business and it is the sale of that which is shown in revenue.

Revenue isn't cash received from your customers. It is the total of the sales, notwithstanding whether they were in cash or on account. One important thing to note here, however, is that the sum is exclusive of any taxes that need to be passed back to the government at some future point.



**HERE'S AN EXAMPLE FROM SAM'S PLUMBING:**

*Here's an example from Sam's Plumbing:*

*By now you are aware of Sam and the plumbing business she operates with the help of her apprentice Stash.*



By now you are aware of Sam and the plumbing business she operates with the help of her apprentice Stash.

*Sam earns money in two different ways:*

*First of all, she charges for her time fixing plumbing or installing new plumbing for people. Secondly, she charges for the supply of equipment such as hot water units. She also adds a charge for the materials she uses in fixing or installing plumbing.*

*Sam and Stash have just finished up a tiring day at the McKenzie's place, installing a new hot water service and running an upgraded gas line under their driveway. The hot water unit cost Sam \$1,000. The parts used to run the new gas line as well as connect it all up cost Sam \$375. Sam and Stash took six hours all up to install the new line and hot water unit. She had quoted the McKenzies \$1,300 for the hot water unit, \$400 for parts and \$800 in labour charges.*

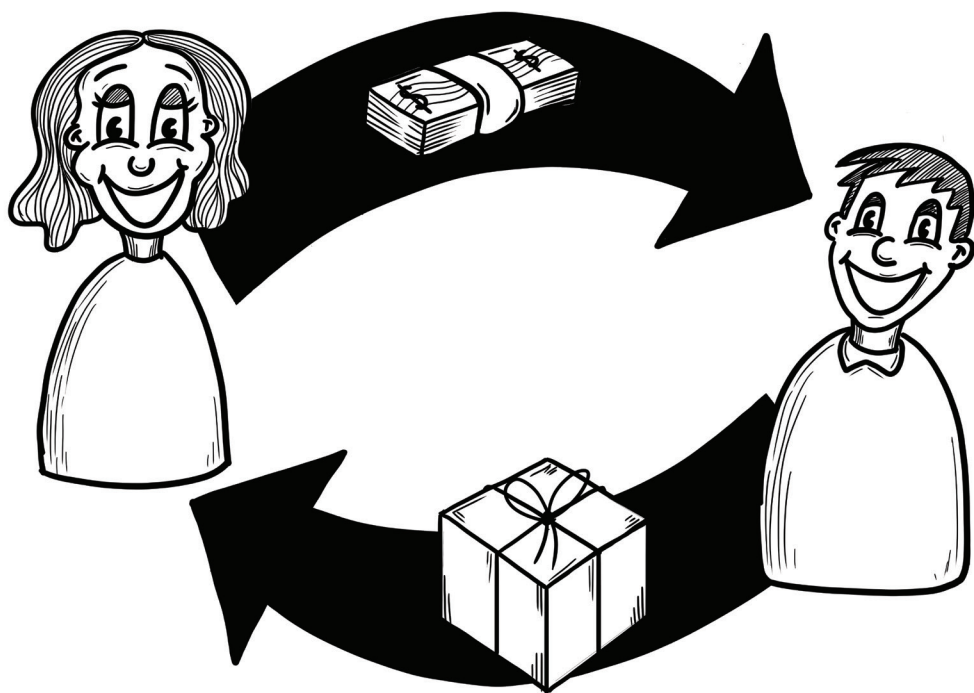
*The Revenue of Sam's Plumbing would look like this:*

<b>Revenue</b>	
<i>Sale of Goods</i>	<i>\$1,300</i>
<i>Sale of Parts</i>	<i>\$400</i>
<i>Service Charges</i>	<i>\$800</i>
<b>Total Revenue</b>	<b>\$2,500</b>

### COST OF GOODS (OR SERVICES) SOLD

The next major category to understand is the direct costs associated with making sales. By direct, I mean that you can attribute the cost to the actual sale made.

The main element of the Cost of Goods sold is what it cost you to buy that item. Depending on your business, the Cost of Goods can also include distribution costs (i.e. shipping) and/or the labour costs of making and distributing the item.



You can think of this in simple terms. If you were to buy an item for \$20 and sell it for \$50, you have made a margin of \$30.

**SAM'S PLUMBING:**

*In the above example, we learned about some costs that Sam had in supplying the hot water unit for the job at \$1,000 and parts for the installation at \$375. This means that the total cost of goods sold for the McKenzie job was \$1,375*

<b>Cost of Goods Sold</b>	
<i>Purchases</i>	<i>\$1,000</i>
<i>Materials Used</i>	<i>\$375</i>
<b>Total Cost of Goods Sold</b>	<b>\$1,375</b>

*A couple of notes here. Adjustments to inventory or stock that is held by the business are reflected in the Cost of Goods Sold area. Without getting too technical, if Sam had parts on hand of \$500 before the job, she purchased \$100 worth of materials during the job and had \$225 worth of materials at the end of the job, this is how the cost of materials would be calculated:*

<i>Opening Cost of Materials</i>	<i>\$500</i>
<i>Add Materials Purchased</i>	<i>\$100</i>
<i>Less Closing Materials</i>	<i>(\$225)</i>
<b>Total cost of materials</b>	<b>\$375</b>

*Wages: A final note is that even though Sam and Stash allowed for their labour costs, it isn't really necessary to attribute part of their wages to Cost of Goods sold as this becomes quite complex to calculate and manage. It is sufficient to say that Sam and Stash had to be paid in any case and so their costs are fixed. If they had to hire a casual labourer for this job only, then it would be appropriate to add that labour cost into the Cost of Goods Sold.*

GROSS PROFIT

Gross in this context doesn’t mean off-putting or distasteful. It simply refers to the amount of profit that the business earns before any fixed costs or overheads are taken into account. It is important because it tells the business what ‘Margin’ they received.

The Margin is simply the amount over the cost of a good or service sold. For example, if you purchased an item for \$100 and sold it for \$150, you would have ‘Margin’ of \$50 on that transaction. If that was the only transaction, you would have made a \$50 Gross Profit for the period. The \$50 is then available to meet those overheads or fixed costs that you would have to pay regardless of whether you made that sale or not.

You’ll find out more about Overheads in the next section.

Sam’s Plumbing

Total Revenue	\$2,500
Less Cost of Goods Sold	(\$1,375)
Gross Profit	\$1,125

## OVERHEADS

Your Overheads are costs your business incurred, during the period that the report is for, that cannot be directly attributed to individual sales. Examples of Overheads would be rent on a building, your telephone/internet expenses and electricity.



Sometimes, these Overheads can be called Fixed and Semi-variable Costs, both of which are helpful descriptions.

Fixed Costs are those that do not vary with the amount of sales you make. Rent is an example. If you rent an office, it does not matter whether you sell 1,000 units or just one, you will still pay the same amount.

Semi-variable Costs are those that vary only very slightly, depending on the volume of sales. Electricity might be an example of a cost that goes up when the business has a lot of activity as compared to when it is shut down. But it would be too hard to try and attribute the cost of electricity in most cases to an individual sale.

**Sam’s Plumbing**

Sam had to pay for petrol for the van \$100, registration for the van \$250, the electricity bill for her workshop \$145 as well as the rent of \$150. She pays Stash \$150 in that same period.

Sam’s Plumbing Overheads	
Petrol	\$100
Registration	\$250
Electricity	\$145
Rent	\$150
Wages	\$150
Total Overheads	\$795

**NET PROFIT**

The Net Profit of the business is calculated as the Gross Profit less the Overheads. If you think about it, this represents the amount of money from the sale that is left over after accounting for the cost of it (Cost of Goods Sold) as well as all the other costs associated with running the business (Overheads).

**Sam’s Plumbing:**

Total Revenue	\$2,500
Less Cost of Goods Sold	(\$1,375)
Gross Profit	\$1,125
Less Overheads	\$795
Net Profit	\$330

### RECAP

The Profit and Loss (or Income Statement) records the revenues and expenses of the business over a period of time. It can be any period but Yearly, Quarterly and Monthly are most common time periods for the Profit and Loss. The Revenue of the business includes sales of goods or services as well as things like interest and sales of assets no longer needed.

Cost of Goods Sold is the cost to the business of supplying the items for sale along with its directly associated costs such as freight or the labour cost to make or assemble it.

The Gross Profit is the difference between the Revenue and the Cost of Goods Sold and represents the amount of money available to meet all the overheads of the business as well as the return on investment to the owners.

Overheads or Fixed Costs are those costs that the business must incur (or be liable to pay) whether they sell anything or not.

Net Profit is the Gross Profit less the Overheads and can be considered the amount left over for the owners and sometimes to pay tax as well.

**TAKE A LOOK AT YOUR OWN BUSINESS PROFIT AND LOSS BEFORE YOU GO ANY FURTHER.** Make sure you understand all of the items in it and that it makes sense to you. If in doubt, your accountant should be happy to give you advice. Take a look at the different formats you can see this information in on your accounting software. Note, the main items of Revenue, Cost of Goods Sold, Gross Profit, Overheads and Net Profit are consistent no matter what the presentation.

## REPORT #3:

# THE CASH FLOW STATEMENT

The final report is not one you may be familiar with as it is not often included in annual accounts prepared by your accountant.

This report is the Cash Flow Statement - it measures cash into and out of the business for a specified period of time. It is a hybrid of a report, in so much as the Closing Cash position is at a point in time, whereas the transactions contained within the report are the accumulation for any given period.

The report starts with the Opening Cash Balance. This is the same balance as you would find on the balance sheet for that particular point in time. For example, if the opening cash balance on 1st January was \$34k, then the balance sheet as at 31st December would also be \$34k.



The report starts with the Opening Cash Balance. This is the same balance as you would find on the balance sheet for that particular point in time.

The report then measures the inflow and outflows of cash for the period under three different categories: Cash from Operations; Cash from Investing Activities; and Cash from Financing Activities.

Operations, investing and financing can be cash positive or negative. The total of those three is called Net Cash Movement.

When added to the opening cash balance, this will equal your closing cash balance, which should be the same as the cash balance found on the balance sheet for the corresponding period.



In short form:

Opening Cash Balance

+/- Cash from Operations

+/- Cash from Investing

+/- Cash from Financing

= Closing Cash Balance

Cash is a very important resource for your business, as we will discover in the following chapters. This report gives the business owner the answer to the age-old business owner question which is, “If I made a profit of \$100k, why doesn’t my bank account have \$100k in it?”

To help answer this question, here are some specifics which will help you understand your Cash Flow Statement:

### **CASH FROM OPERATIONS**

Cash from Operations is the starting point for understanding the cash flow statement. It can be explained as the operating profit for the given period, adjusted for non-cash items, as well as, the adjustment to Working Capital for that period.

The reason operating profit may need adjustment for non-cash items is that some items charged to the profit and loss do not have a cash impact. Depreciation, which as we saw when we reviewed assets, is an allocation of costs previously incurred. If it is charged to the profit and loss during a period, your accountant will need to add that back.

In addition, sometimes businesses make an allowance for future expenses that should be attributed to the current period. These are called provisions and whilst they operate to lower the profit for a period, they have no cash flow impact until they are actually paid for at some future point.

### WORKING CAPITAL

Working Capital is the money needed to fund operations, taking into consideration that there may be a timing difference between when you need to pay your suppliers and when you get paid by your customers.



A reduction in working capital will result in more cash in your bank and an increase will result in less cash in your bank.

This typically works as follows:

**Accounts Receivable:** When you first make a sale on credit terms, you may allow a period, say 30 days, for your customers to pay you. The accounts receivable balance at the date of the closing cash balance can be calculated as Opening Accounts Receivable balance PLUS new credit sales for the period, minus cash receipts from customers.

Depending on the amount sold during the period and the cash received from customers who have accounts due for payment as per their payment terms, your closing balance of accounts receivable may go up or down. If it goes up, that means you are owed more money now than you were at the start of the period. This adds to the working capital required in the business.



If the balance goes down,  
it will reduce the working  
capital for the period.

**Inventory:** You most likely won't sell all of the inventory you have in any given period. This means you will have an inventory balance at the start of your period and an inventory balance at the end. The closing inventory balance is calculated as Opening Inventory plus inventory purchased during the period, minus inventory sold during the period.

An increase in inventory means more working capital was required and decrease means less working capital was required.

**Trade Creditors:** Just as you may give credit to some of your customers, some of your suppliers will give you credit. Those credit terms will not match up perfectly with the trading for the period. The Trade Creditors Balance is calculated as Opening Trade Creditors plus purchases on credit, minus payments to creditors.

An increase in the closing balance is actually a reduction of working capital as you received goods or services but didn't need to invest cash in them. A decreasing balance, however, will use more of your cash and therefore actually increase working capital for that period.

Here's an example so that it will be a little clearer.

During the month, we made a profit of \$350. Our accounts receivable balance increased by \$25, our trade creditors balance decreased by \$15 and our inventory balance stayed the same. This is what cash from operations would look like for the month:

<i>Cash from Operations</i>	
<i>Operating Profit</i>	<i>\$350</i>
<i>Increase in Accounts Receivable</i>	<i>(\$25) - use of cash</i>
<i>Decrease in Trade Creditors</i>	<i>(\$15) - use of cash</i>
<i>Net Cash from Operations</i>	<i>\$310 - this is the amount of cash that our bank account would have gone up by as a result of trading operations during the month.</i>

## CASH FROM INVESTING

Cash doesn't just come into our bank accounts and sit there forever. We need to use this cash at times and this category is about using the cash for purposes of investing in the business.

Investments that fall under this category include the purchase of a new machine; the purchase of a motor vehicle; investing in long term bonds (more than one year); and the purchase of land or buildings.

Of course, we don't just invest. Sometimes we divest, which means we sell these items.

An investment is use of cash and will therefore reduce the overall cash at bank position.

A divestment is a source of cash, which will increase the overall cash position. Note that it doesn't matter for this purpose whether the asset was paid for in cash or with credit as this will be adjusted in the next category. Note that divestment will have a bracket around it to indicate a negative.

<b><i>An example of Cash from Investing:</i></b>	
<i>Purchase of new drill</i>	<i>(\$1,200)</i>
<i>Sale of second-hand office desk</i>	<i>\$100</i>
<b><i>Net Cash from Investing</i></b>	<b><i>(\$1,100)</i></b>

### CASH FROM FINANCING ACTIVITIES

Businesses often leverage other people's money to fund both investments and working capital. When you borrow money, that is going to increase the cash in your bank account. When you pay back that money, either in whole or instalments, that decreases your cash at the bank.

One note here is that the payment of dividends or distributions to owners shows up in this category as it can be considered that undistributed profits are similar to a loan to the business. When those profits are paid, this is a repayment of that loan.

<b><i>An example of Cash from Financing Activities</i></b>	
<i>Finance for purchase of new drill</i>	<i>\$1,100</i>
<i>1st Instalment of new drill finance</i>	<i>(\$100)</i>
<i>Owners drawings for the month</i>	<i>(\$200) - Note if this was a salary payment it would have been included in operating profits. As it is, it is simply a loan from this business to the owner OR a distribution of profits. Either way, it has reduced the cash in the bank.</i>
<b><i>Net Cash from Operations</i></b>	<b><i>\$800</i></b>

*The way in which the whole report works based on examples of an opening balance of \$250 in the bank is as follows:*

<i>Opening Cash at Bank</i>	<i>\$250</i>
<i>Cash from Operations</i>	<i>\$310</i>
<i>Cash from Investing</i>	<i>(\$1,100)</i>
<i>Cash from Financing</i>	<i>\$800</i>
<b><i>Closing Cash at Bank</i></b>	<b><i>\$260</i></b>

### RECAP

The Cash Flow Statement records the movement of cash into and out of the business over a set period of time.

It helps to explain where the cash came from and where it went.

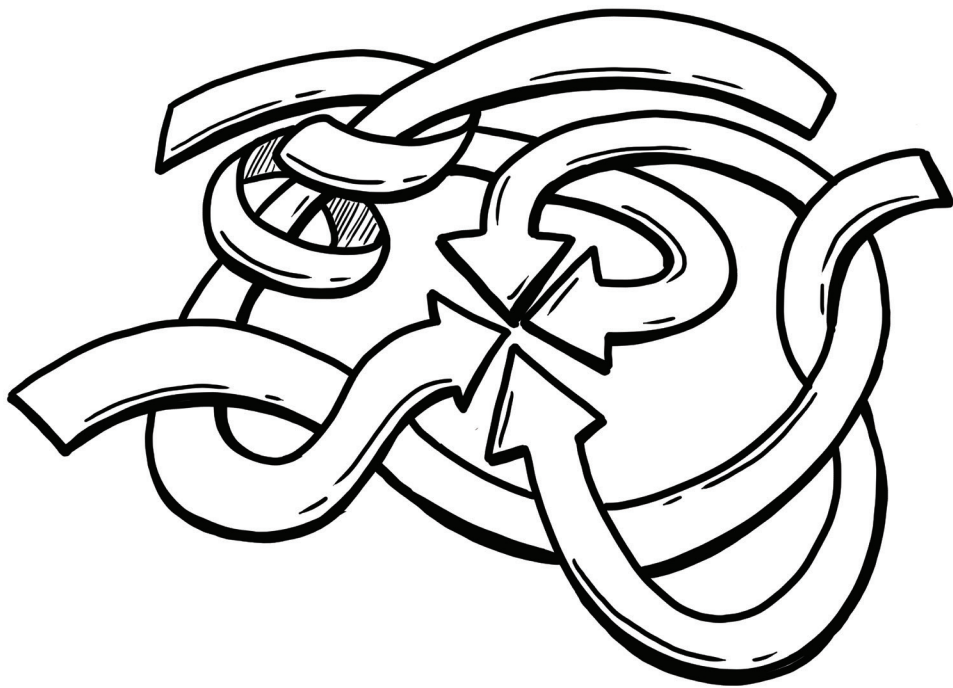
Cash sources and uses can be categorised as Operating, Financing and Investing. This helps the business owner to understand exactly which area of the business the cash is coming or going to.

The final number on the Cash Flow statement is the cash that was available at the end of the period for which the Cash Flow statement is prepared. This is roughly equivalent to the cash in the bank account at that end date of the report.

**TAKE A LOOK AT YOUR OWN BUSINESS CASH FLOW STATEMENT BEFORE YOU GO ANY FURTHER. YOU MAY NOT FIND IT EASILY AS MANY ACCOUNTANTS DO NOT PREPARE IT AUTOMATICALLY FOR YOU.** Have a look in your Accounting Software and see if you can get it to produce one for you. Ask your Accountant or Bookkeeper if you have any trouble working it out. It can be a bit tricky!

## HOW THE THREE REPORTS INTERSECT

It is important to note that there is an intersection between your three most important business reports which ties them all together.



The Balance Sheet contains elements from the other two reports, specifically the Closing Cash Balance and the Current Period Profit.

The Cash Flow Statement also has the current period profit as the starting point for cash from operations.

The final number in the cash flow statement is the Closing Cash Balance. This is the number that is on the Balance Sheet. The profit and loss does not contain any numbers from the other two reports, but gives its net profit to both.



All the reports should be consistent with each other, reporting slightly different information but based upon the same stories as converted to numbers.

Ask your accountant about how all these terms apply to your business. If they are a good accountant and are invested in you as a client, they will be able to show you some specific examples based directly on your numbers.

Don't worry if you feel overwhelmed by the above information while you're learning about your business finances. It is a lot to take in and accountants spend many years becoming experts. Being aware of the terms is an excellent starting point.



As you familiarise yourself with reports and statements on a regular basis, you will gain confidence and clarity.

### **A WORKED EXAMPLE OF THE THREE MAIN REPORTS**

As I have mentioned, accounting is the process of turning the stories of your business into numbers. Those numbers can then be used in universal ways to derive key information about your business that you may not have realised before.

Take a look at an example of the day in the life of a business and how that day translates into numbers and forms the basis of the three key reports we have outlined above.

### A DAY IN THE LIFE OF SAM'S PLUMBING

Sam woke to a text from her bank that said she was down to just \$875 in her bank account. She knew that if she was going to be able to pay Maximilian supplies the \$450 she still owed on the new drill she had purchased, she had better get out there and do some plumbing! Besides, her apprentice Stash was due for his salary today and she didn't know about the fuel situation in the van.

Sam met Stash as usual and they headed off to their first job, the installation of a new hot water unit for the O'Donnell family. Before they could go to the site, they dropped in at the hot water supplier and picked up the new unit which cost \$600, which Sam put on her trade account. The day went as planned and after a few twists and turns, Sam and Stash had successfully installed the hot water unit at the O'Donnells and due to the new software Sam had started using, she was able to immediately write up an invoice for them worth \$2,000.

Sam and Stash then drove back to the office and while Stash restocked the van, Sam paid Maximilian Supplies the \$450 she owed them and transferred \$150 into Stash's account.

She sighed as she checked the balance of her account. It was now down to just \$275, but she knew that the O'Donnell invoice would be paid within a week and that the job she and Stash did for Star Corp last week totalling \$1200 would likely be paid tomorrow. Sam then paid herself \$100 so she could pick up some fish and chips for her family for dinner.

***Let's turn this story of a day in the life of Sam's business into numbers:***

- 1) Opening Cash Balance = \$875
- 2) Purchase of Hot Water unit - \$600 - Increase in Inventory and an increase in Trade Creditors.
- 3) Installation of Hot Water Unit - Decrease in Inventory of \$600 and an increase in Cost of Goods sold of \$600.
- 4) Invoicing O'Donnells - Increase in sales for \$2,000 and an increase in Accounts Receivable \$2,000
- 5) Payment of \$450 to Maximillion - Decrease in Trade Creditors and Decrease in Bank
- 6) Payment of \$150 to Stash - Increase in wages overhead and decrease in Bank.
- 7) Payment of \$100 to Sam - Increase in Dividends paid and decrease in Bank

We will start with the Profit and Loss as we will need that number for our balance sheet and Profit and Loss:

***Profit and Loss - Sam's Plumbing for the day ended today***

<b><i>Revenue</i></b>	
<i>Sale of plumbing supplies and labour</i>	\$2,000
<b><i>Total Revenue</i></b>	<b><i>\$2,000</i></b>

<b><i>Less Cost of Goods Sold</i></b>	
<i>Purchase of Hot Water Unit</i>	\$600
<b><i>Gross Profit</i></b>	<b><i>\$1,400</i></b>

<b><i>Less Overheads</i></b>	
<i>Stash Wages</i>	\$150
<b><i>Net Profit</i></b>	<b><i>\$1,250</i></b>

*Balance Sheet for Sam's Plumbing as at today*

<b>Current Assets</b>		
Cash at Bank	\$175	
Receivables        - Star Corp	\$1,200	
- O'Donnell	\$2,000	\$3,200
<b>Total Current Assets</b>	<b>\$3,375</b>	

<b>Non-Current Assets</b>		
Equipment -        - Drill	\$450	
- Other	\$5,000	\$5,450
Van	\$20,000	
<b>Total Non-Current Assets</b>	<b>\$25,450</b>	
<b>Total Assets</b>	<b>\$28,825</b>	

<b>Current Liabilities</b>	
Trade Creditors	\$600
<b>Total Current Liabilities</b>	<b>\$600</b>

<b>Non-Current Liabilities</b>	
Loan Mum and Dad for Van	\$15,000
<b>Total Non-Current Liabilities</b>	<b>\$15,000</b>
<b>Total Liabilities</b>	<b>\$15,600</b>
<b>Net Assets</b> <b>(Total Assets Less Total Liabilities)</b>	<b>\$13,225</b>

<b>Equity</b>	
Current Day's Profit (per P&L)	\$1,250
Prior Profits not yet distributed	\$12,075
Less Profit distributed today	(\$100)
<b>Total Equity</b>	<b>\$13,225</b>

***Cash Flow Statement Sam's Plumbing for the day ending today***

<b><i>Opening Cash at Bank</i></b>	<b><i>\$875</i></b>
------------------------------------	---------------------

<b><i>Cash from Operations</i></b>	
<i>Profit for today</i>	<i>\$1,250</i>

<b><i>Adjustment to Working Capital</i></b>	
<i>Increase in Accounts Receivable</i>	<i>(\$2,000)</i>
<i>Increase in Trade Creditors</i>	<i>\$150</i> <i>(\$1,850)</i>
<b><i>Total Cash from Operations</i></b>	<b><i>(\$600)</i></b>

<b><i>Cash from Financing</i></b>	
<i>Payment of Dividend to Sam</i>	<i>(\$100)</i>
<b><i>Total Cash from Financing</i></b>	<b><i>(\$100)</i></b>

<b><i>Cash from Investments</i></b>	
<i>No movement</i>	
<b><i>Net Cash Movement</i></b>	<b><i>(\$700)</i></b>
<b><i>Closing Cash Balance (Opening plus Net Cash)</i></b>	<b><i>\$175</i></b>

Congratulations! Now that you have an awareness of the most important financial reports, you are ready for the next section, which is really where the magic happens. It's where we turn all these numbers into new stories about the business that we can really use to help the business generate more profits and cash and avoid the pitfalls of the falling tide.

### RECAP

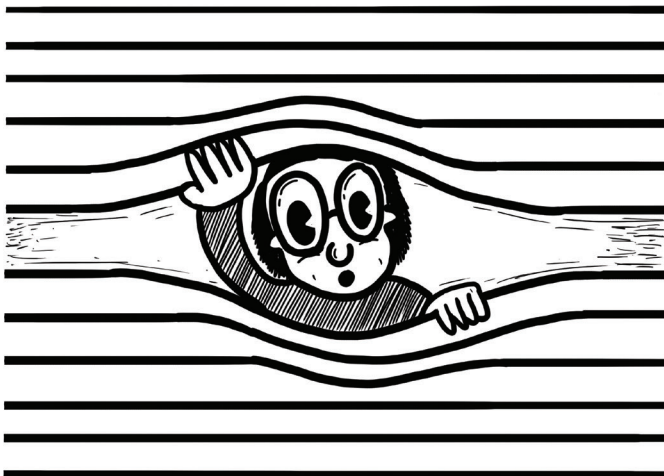
Your most important financial reports are the Balance Sheet, Profit and Loss, and Cash Flow Statement. These show different diagnostic information about the business that can be used to understand exactly what you own and owe, how much profit you are making and what impact that is having on your bank account.

**GRAB LAST YEAR'S FINANCIAL REPORTS AND GO THROUGH THEM TO FAMILIARISE YOURSELF WITH HOW YOUR BUSINESS IS BEING PRESENTED. SEE IF YOUR ACCOUNTING SOFTWARE WILL PREPARE THE THREE MAIN REPORTS FOR YOU.** Ask your bookkeeper or accountant to configure your system so you can easily access your numbers.

# READ BETWEEN THE LINES

As a novice in an aeroplane, the gauges you see in the cockpit are meaningless. Once you understand what they do, you can begin to read and interpret them. It's like in the movie *The Matrix*, where the character Mouse is introducing Neo to the woman in the red dress. He explained that he was so proficient at reading the matrix code that he no longer needed to see the generated images.

Now you have a better awareness and understanding of the three main reports and what they do, you can now start to use them to understand exactly how your business is performing and more importantly, what control 'levers' you can pull on to impact your overall profits and cash flow.



## BALANCE SHEET

In chapter four, we discussed how the balance sheet was put together and what the numbers on it represented in your business. We learned that the balance sheet is just stuff your business owns, which is the total of what you owe on it plus how much of it you own outright.

But it is the relationships between the items on the balance sheet that can give you the valuable insight that will help you surge ahead in the good times and weather the storms in the bad times.

## CURRENT ASSETS / CURRENT LIABILITIES

### - CURRENT RATIO

You now know that current assets are those assets that can expect to be converted to cash within 12 months. You also know that current liabilities are those that will need to be paid for with that cash within 12 months.

I think you can already see that it is a great idea for a business's cash flow for current assets to exceed current liabilities. If they don't, trouble is brewing. This might happen to you if you say, purchased goods to resell, but were unable to for some reason, maybe they were defective or just the wrong product at the wrong time. If your supplier gave you credit, this could cause the current ratio to dip outside of your favour.

Another common way for the current ratio to be out of alignment is if you were taking too much cash out of the business and spending it on yourself. It is common for business owners to take cash out of the business before the business has profits to support that cash.



If you don't have ready access to put those funds back into the account, then you are relying on future profits to pay for current debt. This is a recipe for certain disaster as once again, during the good cycle, you will be OK, but when a downturn happens, you will not be able to pay your suppliers or tax liabilities. This threatens the very existence of your business!

Don't panic if your balance sheet doesn't look the way you want it to. The important thing is to be aware of its status and collaborate with your accountant to get it on the right track.

### ACTION ITEM

Get your balance sheet out and calculate the current ratio as follows:

Current Assets divided by Current Liabilities. Check your score as follows:

**More than 3** - You may actually have an issue of too much cash, too much stock or too many of your customers or clients owing you money.

**Between 1.5 and 3** - This is considered to be ideal for most industries.

**Between 1 and 1.5** - You may need to pay close attention to cash flow management.

**Less than 1** - You need to take immediate action in order to ensure your business can survive a downturn.

## CONTROL LEVERS

In order to adjust your current ratio, you have a number of big levers you can adjust:

**Cash at Bank:** If you have too much, consider paying a dividend or distribution to your owners or investing in longer-term assets. If you have too little, the action you take will depend on the other items that make up your current assets and liabilities.

**Stock/Inventory:** If you have too much stock, consider liquidating this stock by having a sale or looking for ways to convert it back to cash, such as selling it for a massive discount to a wholesaler.

**Caution:** Some stock items that have a very high margin but low demand may warrant retention. An example of this is the set of very expensive screwdrivers in a convenience store. They may wait for up to two years before somebody is in desperate need of them and willing to pay the very high price. If you have some stock in this category, consider reclassifying it into the Non-Current asset class as it is more like an investment rather than a current asset.

**Debtors/Accounts Receivable:** Too much in this account can mean you have poor control over your customers and credit given in general. There is a big danger that you will fail to collect all the debt owed to you.

**Consider this:** If your product has a 30% margin on it, writing off a debt of \$10,000 means you need to sell \$30,000 worth of items just to make up for that loss. Often business owners think they only need to sell \$10,000 to catch back up but there is a much more sinister side to bad debts that makes them, well... bad. You need to review your credit procedures and get on the phone to rein those receivables in and convert them to much needed cash!

**Trade Creditors:** You can always negotiate with your suppliers to extend the terms if you really need to. For the same reason you don't want your debts to go 'bad', they will want you to eventually pay them in full and buy more as well.

**A word of caution:** Don't try to negotiate with your landlord if at all possible. You can find yourself locked out of your business premises for all sorts of reasons and this is one supplier you can't afford to have worrying about whether you will pay your rent.

**Tax Liabilities:** It is often possible to negotiate extended terms with tax authorities, although most are awake to the trick of building tax liabilities and then going into liquidation and not paying them at all. Apart from the moral issues this presents, there are often ways the tax office can make business owners personally liable for business tax debts. You don't want to lose your wealth as well as your business.

There may be many other levers that can be adjusted in order to get your current ratio back on target for your business. As per chapter three, I highly recommend consulting your accountant to get a 12-month plan of action in place. Remember, the best time to do this is when you are in the upcycle. Life becomes much more difficult in the down cycle.

## TOTAL LIABILITIES / EQUITY

### - DEBT TO EQUITY RATIO

The purpose of this calculation is to drill down on how the business has been financing its growth. The reason this works in this way is that we know that assets minus liabilities is equal to equity. Therefore, if you increase your liabilities without increasing equity, you will have increased your assets as well.

When this happens, it can be said that the additional assets were funded by liabilities, whether they were directly or not. If, on the other hand, your assets went up but your liabilities stayed the same, you have funded the assets with profits that instead of being distributed to the owners, were used to buy assets.

### ACTION ITEM

Get your balance sheet out and calculate the debt to equity ratio as follows:

Total liabilities divided by total equity. Check your score as follows:

**More than 2** - You finance your assets with more than \$2 of debt for every \$1 of owner's funds. This might be fine at start-up but you are heading for trouble if you can't use the assets to generate sufficient profits and cash flow to be able to repay the debt.

When the tide goes out, the banks will ask for some or all of their money back and if assets cannot be sold to repay this debt the business will likely fail. In good cycles, it's easy to borrow money to buy more assets and everything is rosy but beware of downturns in either asset values or the availability to borrow more as your business may be very exposed.

**Between 1 and 1.5** - This is considered ideal for most businesses. You are using debt or other people's money to leverage into profit and cash-producing assets but you are also funding those assets with profits and your own cash too.

There is a risk, however, that you are not being aggressive enough, depending on the business cycle you are in and you may be missing out on profits and cash because you are holding off on buying assets that can give you more profits.

**Less than 1** - This means you are funding the assets considerably and you are either missing out on opportunities or not paying your investors (and you!) enough return.

### CONTROL LEVERS

In order to adjust your Debt to Equity Ratio, you have a number of big levers you can adjust:

**Fixed Assets:** If your business makes money from property, plant and/or equipment you could consider adding to these, funding either from past profits (instead of distributing to the owners) or from borrowings or a combination of both. If you have excess assets that are no longer producing income, consider selling them.

**Trade Creditors / Tax Liabilities:** If you need to fund more inventory or give your larger customers more credit, you can consider using these short term liabilities to fund. Of course, supplier and government relationships are vital but you can often extend terms. Be very cautious about using short term liabilities to fund long term assets, as the payback is quick but you can leave yourself with cash flow issues.

**Bank Debt:** You can extend your bank debt to fund the purchase of new assets, or if you have excess cash, you could pay down the debt quicker, if allowed. Be cautious in using long term debt to fund short term assets as this may cause structural instability down the track.

**Equity:** You can either pay yourself from current or past profits or hold off on paying profits to preserve cash, depending on which way you want the ratio to go.

## RATE OF RETURN ON ASSETS

### (PROFIT / TOTAL ASSETS)

How good is your business at converting assets to profit? If you invest in anything, you will be looking for a return on that investment. The same is true of your business and so you need to know how hard your assets are working for you. Now you need to have a regard for risk as well as opportunity cost.

Risk has regard for the likelihood that you will lose your investment entirely. You know that if you invest \$1,000 in a government-guaranteed bond, you have a very low risk of losing that investment and as such you don't require a high rate of return.

On the other hand, if you invest \$1,000 in your friend's get rich quick scheme, you might believe you have a high risk of losing that investment and therefore need a much higher rate of return in order to compensate for that possible loss.

For example, if you thought that for every two times you invested with your friend you lose your investment entirely. You would be looking for a return in excess of 50% in order for that investment to make sense. This is the reason that lenders charge more for unsecured loans, than secured loans. They know that their chance of loss is higher and therefore they charge more interest to compensate for that loss.

You need to work out how much you need to return on your investment into your business as well. But that will be a return on your investment which is a different calculation to this one.

This is where the business measures the return on its assets. The return on buying a new machine that will produce more items at less of a cost will be easily justifiable based on return. Buying a new car might be harder to justify.

The other element is Opportunity Cost. Your business will have a finite ability to buy assets and to fund those purchases. The choice to buy one asset therefore means you have less ability to buy another asset. Similarly, the choice to pay off debt or pay returns to the owners will mean you have less to spend on income-producing assets.

When you consider Return on Assets, your choices for choosing what to do with available funds should come down to what expenditure will give you the best return. This is the reason why this is such a powerful ratio in your business—it keeps return at the top of your mind.

The way in which this ratio works is to look at the total profit generated and divide this by the total assets. It doesn't matter whether you use debt or equity to finance the asset as both are finite resources.

### ACTION ITEM

For this calculation, you will need both your **Profit and Loss, and the Balance Sheet**.

Divide the total profit for the period by your total assets. Check your score as follows:

**More than 30%** - You have a great return on your assets in most industries. For every \$100,000 of assets, you are returning \$30,000 of profit or more.

**Between 15 and 30%** - You may still be achieving a good rate of return, however you may find you are not getting a good return on your overall investment in both your time and the money invested in the business at this level. For every \$100,000 of Assets, you are returning between \$15,000 and \$30,000 of profit.

**Less than 15%** - This would be a sub-par rate of return on assets in most industries. It may be that you have a large number of assets but they are not being effectively used or measured.

This is where your fancy company car will hurt you. It doesn't directly add to increased profits so other assets need to compensate for it.

Benchmarks in this area really need to be industry-based but for our small and medium sized business owners, the above guide should make some sense. Consult your accountant on the exact target your business should be aiming for.

### CONTROL LEVERS

In order to adjust your Profit to Assets Ratio, you have a limited number of levers as this is really assessing your management skills in relation to the allocation of the capital of your business.

**Fixed Assets:** If your return is very high, you are extremely efficient in your fixed asset position relative to profits achieved. But if not, you could consider either reducing overall assets by disposing of some. Ensure your assets are effectively managed, which means you know what you have, what condition it is in and ultimately, what contribution towards profits it makes.

**Revenues:** If you can increase revenues by taking on a new service offering that requires a new asset, this might help with return on assets.

**Cost of Goods Sold:** A new asset may be more efficient to bring down the cost of your goods or services. This will increase profits.

**Overheads:** Perhaps you can't or don't want to adjust your assets. You could just work on decreasing your overheads to make more profits on those assets.

A quick note on tax. Small and medium sized business owners will often justify the purchase of new assets, usually a fancy new motor vehicle, based on it creating a larger tax deduction.

Note that this ratio ignores tax and so should these business owners! Fix your targets for asset efficiency and not tax minimisation and let your accountant come up with the strategies for minimising your taxes.



## GROSS MARGIN PERCENTAGE

(GROSS PROFIT / SALES)

The most generic and important profit and loss ratio to consider is the Gross Margin Percentage. The way this can be explained is the amount of gross profits, that is before overheads, each dollar of sales contributes to. Or another way to look at it is to ask: For every \$1 of sales, what percentage of this dollar goes towards meeting my overheads?

This can vary widely from industry to industry, business to business and even within the product or services of your business.



The end result is the average margin percentage over all the sales made during the period you are reporting on.

For example, let's say you sell two types of air conditioners. The first has a sales price of \$1,000 and a cost to you of \$750. Your gross margin on this product then is \$250 (\$1,000 minus \$750) divided by \$1,000 which equals 25%.

The second air conditioner sells for \$400 and has a cost to you of \$250. The gross margin on this product is \$150 (\$400 minus \$250), divided by \$400 which equals 37.5%. The second air conditioner sells for less but contributes more in margin.

Now let’s go on to say that during the month, you sold 50 of the first type of air conditioner at \$1,000 and 120 of the second air conditioner at \$400. Your total sales figure for the month was:

<i>50 X \$1,000</i>	<i>= \$50,000</i>
<i>120 X \$400</i>	<i>= \$48,000</i>
<b>Total</b>	<b>\$98,000</b>

<b><i>The cost of these goods sold:</i></b>	
<i>50 X \$750</i>	<i>= \$37,500</i>
<i>120 X \$250</i>	<i>= \$30,000</i>
<b>Total</b>	<b>\$67,500</b>

*This means the gross profit for the period was \$30,500.*  
*The gross margin percentage was \$30,500 / \$98,000 = 31.12%*

**ACTION ITEM**

Calculate the Gross Margin on each item you sell and then the overall Gross Margin you achieved for the past six months on a month by month basis.

What did this information tell you? Do you now understand which products should be pushed (those with a higher margin) and which products drag down your overall average margin achieved? This information alone will give you important insights into what drives profits in your business.

## CONTROL LEVERS

The cost of the products you sell is the key to improving your Gross Margin percentage.

**Sales:** Do you know which items you can discount and by how much? Do you know the relative importance of each product you sell towards your overall profit? Should you not sell some products as they may even cost you more than their selling price? This is perhaps the most important thing to understand in any business.

**Purchases:** If you make your product, can you make it cheaper than you currently do in order to drive more Gross Margin? If you buy your product, can you source an alternative supplier or buy more to bring the cost per unit down?

## A NOTE ON INVENTORY/STOCK ON HAND

You might be confused about buying more inventory and bringing the overall margins up as it brings costs down.



The amount of stock you have at the end of the period does not add to the cost.

It is only the cost of those actual items you sell that is taken into account to record your cost of goods sold and therefore your gross profit.

## UP TO DATE ACCOUNTS

Hopefully you are now well on the way to setting the targets for your business so you can maximise the effectiveness of your business and make the most profit you can, no matter what the business cycle you are in.

Remember, what you can measure you can manage. This means you need to have accurate and well set out accounts.

Unless you are a listed company, there is generally no real requirement to set your accounts out in a certain way. However, the more you care about how your Balance Sheets and Profit and Loss statements look, the more accurately you can calculate and measure your ratios and your next moves.

Work with your accountant or bookkeeper to ensure your accounts are accurate and set out in such a way that you can measure and therefore manage your business.

### RECAP

Reading between the lines is the process of understanding what your accounts are telling you about your business right now and how to improve it in the most efficient way.

The ratios use both the balance sheet, and profit and loss. You are looking for positive trends after you make adjustments to the key items identified. It's very important to have up to date numbers to make this part of your regular business review.

**CALCULATE YOUR KEY FINANCIAL RATIOS AND DISCUSS WITH YOUR ACCOUNTANT.** Set targets and monitoring for the next 3 months.

# CASH FLOW MATTERS

The job of the entrepreneur is to turn things they buy or make or services they provide into cash. And hopefully much more cash than they paid for it, given the time and effort that went into making and selling it.

Note that profit isn't the end goal. As we learned in chapter three, profit is an opinion. It is cash in your bank account that is a solid fact.

The way business works in terms of selling goods is you start out with a certain amount of cash and then you buy some things and turn those things into something else or just sell them. The customer pays you for the goods they purchased from you and you should end up with cash at the end.

In a major, one-off transaction such as a large property development, it might work out that way. But when your business has a continuous nature and you need to adjust for different selling cycles and business cycles, you need to be very aware of just how much cash you need at any point in time.

More isn't necessarily better when it comes to cash although its certainly better than not enough! This is because the return you receive from just having cash in the bank is virtually nothing. Especially when compared to the returns you can get from increasing your stock/inventory or the purchase of a machine to produce your goods.

This is where the cash cycle comes in.

## THE CASH CYCLE

Each business will have its own unique cash cycle.

This cycle is the process and time it takes for \$1 spent in your business to come back to your bank, and hopefully with a few friends along with it.

Consider a typical cash cycle in a wholesale business. Purchases are made from the manufacturer. Through good trading and negotiation, the business might have 60 days to pay for these purchases. Sales are then made to retail customers, who in turn might have 30 days in which to pay for those sales. If it took 30 days to sell all the items, you should receive the proceeds from all of the sales by the time the supplier's payment is due.

While it is essential to understand your own business's unique cash cycle, most businesses operate on a continuous nature which means it always feels like cash from sales is coming into your business and payments to suppliers are going out. This can blur the lines of exactly what your cash position is at any point in time.

## WHY IS CASH SO IMPORTANT?

Cash is king as they say. This is because cash is the lifeblood of any business. If you don't have enough of it, you will wither and die.

Imagine a scenario where you have been trading very profitably. Your accountant is very pleased with your results and you have worked very hard to achieve them. But out of the blue, a large bill comes in. Often it is the government coming looking for its share of your profits. If you don't have the cash to pay, all of sudden your hard efforts look like they are going to come unstuck. What has happened?

As we saw in the section about your three most important reports, cash from operations is only one of the sources and uses of cash in a business. You might have also purchased equipment with the cash or paid out loans or made payments to the business owners. While it can be good to have a cautious view of the management of cash from investments and financing, sometimes the cash from operations just doesn't come in when you expect it to.

## HAVING A CASH BUDGET

Creating a Cash Budget can be a very effective way of managing your cash flow within any business. To create a Cash Budget, you will need to have an in-depth knowledge of things like how long your customers take to pay you, how often you pay your suppliers and when big things like tax payments, capital purchases and debt repayments are due.

Of course, your budget can be flexible. You can make assumptions on many of these items, which can then be progressively refined as you go on. The key to effective cash management is to ensure you test your assumptions constantly by placing actuals alongside the budget and understanding where things didn't go exactly as planned.

With a Cash Budget, it is important to look for areas where you will have an issue with cash flow. Perhaps a large cash deficit is forecast in four months from now. In this case, you will be able to take corrective action now in order to avoid that cash shortfall.

One of the best things about building a Cash Flow Budget is that you get to understand the inflows and outflows of your business like never before.

### STEPS TO BUILDING A CASH FLOW FORECAST

- 1) Go through your bank statements for the past six months and list all of your direct debit payments.
- 2) Make an educated assumption on how long after you sell something you will get paid. Tie this into your sales forecast. Keep it simple, such as 50% in the same month as sale, 30% in the month following and 20% in the month following that.
- 3) Work out when you will purchase your inventory (if applicable) and factor that into your cash flow budget. For example, \$50k every 2nd month.
- 4) List the largest overhead items that need to be paid for in the month they are incurred such as wages and rent.
- 5) In the same way you did for your sales receipts, work out when you pay your suppliers other than the large ones listed in step four above, and input that into your budget. For example, 40% in the current month, 40% in the month after and 20% in the month after that.
- 6) Input estimates for when taxes are due.
- 7) Input when capital expenditure such as a new car or equipment will be purchased.

If you follow the suggested template, you will have an excellent basis for becoming more and more accurate with these forecasts over the next six months.



# TURNING ITEMS INTO CASH

## INVENTORY TURNOVER (COST OF GOODS SOLD / AVERAGE INVENTORY)

This is the number of times you turn over your inventory in a year, on average.

Having your cash tied up in inventory for too long can lead to cash stress. But how much is too much?

It all depends on the industry that you are in but one thing is certain, a good understanding of what inventory you have at any point in time is vital to ensuring you don't end up with too few turnovers per year.

Consider actively managing your inventory by keeping an eye on slow moving items and discounting them actively to turn them back into cash. You might not make as much profit as you would have liked or even have made a loss but at least you convert the item back into cash that can be put to more productive uses.

## RECEIVABLE DAYS (AVERAGE RECEIVABLES / SALES)

This is the number of days on average that your customers take to pay you. You might notice that this number is often higher than the days of credit that you have offered your customers. This just means that they are using your 'bank' as a cheap and easy source of cash. You really need to manage that better so that you can gain access to your cash when you need it.

You might want to consider having a credit policy that covers who will get credit, how much credit they will get and most importantly, what action you will take if they don't pay you on time.

## PAYABLES DAYS (PURCHASES / AVERAGE ACCOUNTS PAYABLE)

Payable days can be a bit trickier to calculate as you might need to filter out some purchases and some amounts in accounts payable. It pays to ask your accountant for help with this.

This measure is telling you how long on average it takes you to pay your suppliers. This measure is best used in relation to the receivable's days measure. If for example, your customers take an average of 60 days to pay you, but you pay your suppliers in 30 days, you will have a cash shortage.

One thing you can do to manage this number is to negotiate extended time to pay your suppliers in order to preserve your cash at key times of the year.

### RECAP

Cash is so vital to your business and it's so important to understand the cash cycle of your organisation so you don't run out.

Be aware of the things you can do to generate additional cash flow into your business. Your accountant can help to instigate a discussion with them.

**GENERATE YOUR OWN CASH FLOW FORECAST.**

# FINANCIAL DASHBOARD

When we drive a car, the important information such as how fast we are going, how much fuel we have left and how hard our engine is working are in our field of vision. We can concentrate on what is ahead of us and driving for the conditions, whilst being generally aware of that key information.



A financial dashboard is exactly the same thing. You are embroiled in the day-to-day running of your business and if you take your eyes off where you are going you are bound to leave the road and maybe even crash!

As a business owner, you need to focus on what is in front of you, whether that is hiring a new staff member, dealing with a production issue or launching your latest marketing campaign. But without some key pieces of information that you can access quickly and understand at a glance, you will be driving your business without knowing how fast you are going, how hard you are working your business and how much cash you have left at any point in time!

Now that you have come this far, you are aware of the key reports that drive your business. However, they aren't necessarily going to be available to be constantly updated and in the format you need. The three main reports are best presented with the timeline of one month or even one quarter. On the other hand, dashboard information needs to be real-time, ready to use and easy to see.



There are many dashboards available on the market. Some financial management software such as Xero have a dashboard at their core so you can see some key information at a glance.

No matter how you source or build your dashboard, these are the key things that you should include from a financial perspective:

## CASH AT BANK

There should be two numbers here, the balance as per your bank statement as well as the balance as per your financials. The first number indicates exactly how much cash you have, or at least how much you had at the close of business yesterday.

Many cloud-based accounting systems will pull this information from your bank automatically, which is extremely useful to see how the cash position is currently sitting. You may have multiple accounts and see the balances as per your bank in each account.

Cash is like your fuel for the business. A dashboard means you can see how far from or close to empty you are at a glance.

The second number is Cash at Bank as per your financials. This number represents how many of the transactions that have gone through your bank account have actually been coded and reflected in your financials. The reason this is important is that if you have a large number of unreconciled transactions or a large difference between your bank account and your financials, you may be looking at incomplete or misleading data.

For example, if a large customer has paid \$15,000 into your bank account but you have yet to allocate that in your financials, you may still think they owe you this amount and spend time and energy following up when you don't really need to do so.

## SALES

No business can survive without making sales, so a gauge that shows the level of sales on a week, month or year-to-date basis, depending on your business, will be invaluable to allow you to see if you are on track.

A lack of sales will mean cash flow and profitability issues down the track and so after cash, sales are the next vital piece of information to have a real-time view on.

## ACCOUNTS RECEIVABLE

Who owes you money and when it is due will be a good piece of information to review so you can manage cash collection.

If you see a large account is nearing its due date, reach out to the client to ensure that the cash will be received on time. Similarly, if you know at least the biggest customers who owe you money, you can potentially limit your exposure to them and be aware of how much of sales are going to them.

It's about managing risk as well as cash flow and it really doesn't take more than a glance each day to determine if you have an issue that needs addressing more urgently or not.

Things to look out for include a growing number or value of debt that is outside of trading terms and this is either generalised (could be an issue with credit control or sales) or localised (an issue with a specific customer).

## ACCOUNTS PAYABLE

Having an idea of the amount that will need to be paid if all your debts are paid on time is a good thing. In this case, I recommend that you put things like known government liabilities into the financials as Accounts Payable items. This lets you track the total dollars owing at any point in time. You get bonus points if you are able to tell in which month, fortnight or week the amounts will be due.

The thing to look out for here is extremes at both ends. If you are unable to pay a growing number of suppliers on time, that indicates there may be trouble. If you always pay on time and have a low number of suppliers you owe money to, you may be too liberal with your cash and it may pay to keep some in reserve.

## OTHER KEY ITEMS ON YOUR DASHBOARD

With the growing field of business information, the scope for your dashboard is only limited to the available data in your business. But just like your car dashboard, I believe less is more when it comes to a quick glance at how your business is running. You can always supplement the dashboard with more detailed weekly or monthly reporting and include the three main reports in that as well.

With that being said, if there is a key metric that you can use that is a good litmus test for how your business is travelling, by all means you can include it if the information is real time (or at least up to the end of previous business day) and not too expensive to source. By expensive, I mean a large amount of manual input or formatting.

For example, if you knew your machine production per hour directly translated into sales and cash flow (this would be the case if you had unmet demand for your products) and you could get a real time feed into your dashboard, then this might be appropriate. The big thing to bear in mind is what you are going to do with this information.

### RECAP

Glancing at your financial dashboard regularly is vital to know whether you are about to hit a bump in the road, are going too fast or slow, or if you are about to run out of fuel.

**CREATE YOUR OWN FINANCIAL DASHBOARD.**



# YOUR END GAME

# END

It is sadly all too common that a business owner will get towards retirement before they start thinking of what the ultimate purpose of the business for them was.

As Michael Gerber's E-Myth pointed out, most entrepreneurs are really just technicians who end up in business almost by accident. They were looking to continue to do what they knew without having a real plan to build wealth. Entrepreneurs on the other hand, aren't that interested in what they do, rather in the value that it adds to the world so that they can get a return on their most precious resource, time.

But now that your business finances are 'Unfunkt' and you have a better understanding and control over your numbers, you can now start to think more longer-term and strategically about the natural end point of your business.



You can check in on your finances regularly, understand what's going on and use your knowledge to help your business grow.

## WHAT IS YOUR END POINT?

Ideally, you will have created a business that will go on creating value long after you have passed on the reins to someone else.

The best case scenario as a business owner would be to sell your business at the most optimal point in time for the largest amount of money.



That will give you more financial freedom to choose to do something else of value with your time, money or both.

If you know the direction that you are heading in, there is far more likelihood that you will arrive at a point that makes sense to you, rather than just stumble along letting the business of life take you wherever the wind blows.

I strongly urge you as a small and medium sized business owner to have a detailed business plan that covers the key elements of your business, what you are trying to achieve and what will give you a great sense of whether you are on the right track or not.

However, even if you choose not to go to this level of effort, at the very least you should know what victory looks like. You should also have a sense of what the milestones are along the way so you can measure your progress. Without these things, you are very much at the mercy of business, industry and economic cycles and you may well miss the kinds of opportunities that bring about financial freedom.

## WHAT IS FINANCIAL FREEDOM TO YOU?

I have yet to meet any person who has not expressed a desire to be financially free. But this means vastly different things to different people.

At one end of the scale, financial freedom is defined as having enough money and time to do anything you want whenever you want wherever you want. Skiing in Austria, sailing around the Bahamas, living in Copenhagen or simply making sure that your children have the very best start in life are just a few examples.

At the other end of the scale, it might just mean having enough to eat, shelter over your head and the ability to serve your community.

There is no right or wrong answer and what is true for me will not necessarily be true for someone else. However, if your business is the vehicle to attain financial freedom, you had best be aware of that reality and be working towards it because the vast majority of small and medium sized business owners fall short of their own expectations.

## THE LINE IN THE SAND

No matter what your expectation for the outcome of your business, whether it is closure, sale, merger or building a dynasty for your children to run, you will need to know exactly where you are right now so you can chart your progress towards that end point.

The way in which this can be done easily is to work out what your business would be valued at today. This will allow you to highlight the easiest and best ways to improve that valuation and move towards your ultimate goal. Doing this isn't as complicated as you think so we will step through it now.

## TYPES OF VALUATIONS

In the business world, there are many different types of valuation that can be used to work out a price that two unhurried and knowledgeable buyers and sellers would be willing to exchange the business for.

These are the key ways to value a business:

### 1) MULTIPLE OF REVENUE

In some industries, it is customary to charge a multiple of revenue, such as with rental management—typically up to three times the management fees, or the Financial Planning Industry, which might command three times their annual fees.

This type of valuation is appropriate where the underlying systems and processes of the business are irrelevant and you are really only selling something that people can bolt onto their existing businesses with relative ease.

If your industry is valued on a particular multiple, you only need to concentrate on how many of whatever you have to sell in order to improve. This might mean better marketing or delivery systems but often it's a simple numbers game that means you need to buy other businesses' revenue streams along the way.

If this is your industry, I would still urge you to use the Multiplier of Earnings Before Interest and Tax (EBIT) method because benchmarking our business in this way will ensure you maximise the profits you make up until the time you sell the business.

## 2) DISCOUNTED CASH FLOW

This is a rather complex valuation methodology that looks at the future cash flows of a business, discounted for some predetermined rate of return. It is most often used for major infrastructure projects where the future of cash flows can be relatively locked in and risk therefore plays a much lesser role in determining the value.

This isn't really an appropriate methodology for most small and medium sized businesses.

## 3) MULTIPLE OF EBIT

In this valuation methodology, your business is worth a multiple, such as four times, the Earnings Before Interest and Tax (EBIT). This is an ideal method of valuation to establish the benchmark value of your business as there are so many ways in which you can improve the value once you have settled on the factors that influence the valuation.

**What is EBIT?** EBIT is a measure you might often hear around the business world. It is simply the net profit of the business, adjusted back for any tax or interest expense incurred by the business.

<i><b>For example:</b></i>	
<i>Sales</i>	<i>\$350,000</i>
<i>Less Cost of Goods Sold</i>	<i>\$125,000</i>
<i>Gross Profit</i>	<i>\$225,000</i>
<i>Less Overheads</i>	<i>\$50,000</i>
<i>Less Interest</i>	<i>\$15,000</i>
<i>Less Tax payable</i>	<i>\$40,000</i>
<i>Net Profit</i>	<i>\$120,000</i>
<i>Add back Interest and Tax</i>	<i>\$55,000</i>
<i>EBIT</i>	<i>\$175,000</i>

It is appropriate to remove taxation and interest in order to get a more balanced view of the earnings of the business. Taxation can be different for different types of structures and can vary widely from owner to owner. It is better to remove it to allow for a more consistent value of the business.

Removing interest is important as well as how the owners choose to fund the business, with cash, borrowings or a combination, doesn't really have an impact on the underlying business.

### **AVERAGE EBIT**

We know that EBIT can vary from year to year, depending on the business cycle and other things that come up from time to time. In order to get a more accurate valuation, it might be necessary to average out the last three financial years' EBITs in order to smooth out the effects of the years.

### **REMOVING OWNER EXPENDITURE**

One of the benefits of owning your own business is that you can sometimes pay personal expenses out of the business, even if those expenses weren't really necessary to what the business did.

For example, the business might have a motor vehicle in it but doesn't really need it other than to ferry around the owner. In this case, you can make a further adjustment to EBIT to remove any expenses that were really not needed to conduct the business.

Now you should have a good EBIT figure to start with, we need to multiply it. But by what?

## THE MULTIPLICATION FACTOR

There is actually a science behind the multiplication factor that you should use in order to attain your business valuation.

Sometimes you read about the mysterious “X” factor in valuations but in reality, this number can be assessed with a great deal of accuracy as long as you are open and honest about your own business.

But first of all, what is it? The multiplication factor is a simple re-statement of the risk associated with your business. The risk is just a percentage return that you will require on the investment of your money as well as your time.

Let’s walk through an example.

If you invested \$1,000 in a government-backed term deposit, what is the rate of return you will require in order to compensate you for this risk? It isn’t zero because you will have your money locked away and there is a risk that a better use for that money will come along. But realistically, it will be relatively low, say a maximum of 5% .

In order to calculate the multiplication factor, we simply divide 100 by 5 = 20. You will have an EBIT of  $\$1,000 \times 5\% = \$50$ .  $\$50 \times 20 = \$1,000$ . And so you would assess the value of that investment at \$1,000 which is exactly what you paid for it!

But what happens when you walk up the investment risk table? Blue-chip shares, that is shares in companies that have long, stable trading relationships are generally 10%. The market can fall and things can impact the company's earnings, but generally speaking, think Apple or Microsoft, returns are stable and there are plenty of buyers and sellers in the market.

If you invested the same \$1,000 in blue-chip shares, you would expect an EBIT of \$100 and have a multiple of 10 = \$1,000. Another way to state this is that in order to receive an EBIT of \$100 in blue-chip shares, you would be willing to invest \$1,000.

The next level up is Non-Blue Chip Shares. For these, earnings and dividends are a lot less stable. One year they are up, the next they are down. In order to compensate you for the additional risk, you would be at around 15%.  $100 \div 15 = 6.67$ . Your EBIT at 15% would be \$150 multiplied by 6.67 and you get back to \$1,000.

Notice how the multiplier is falling as the risk gets higher. Now we get to your private business and risk of achieving the average EBIT that you calculated above. The following factors will all influence your ability to generate a consistent EBIT:

- Current Economic Cycle (rising tide or falling tide)
- Industry Cycle (emerging or mature)
- Government policy (self-regulating or intrusive)
- Competitive situation (disruptive or stable)



- Your experience in the business (do you know everything about it or can you be blindsided)
- Your leadership and management abilities (your ability to get things done)
- The systems and processes you have built and implemented (or lack thereof)
- The reliance of the business on you to generate income or produce your product or service
- The volume of sales you consistently generate
- Your ability to source or produce products and services on time
- Your gross margins
- Control over your overheads
- Return on assets employed

Private businesses will generally have a risk rating of 20% or even up to 40%. Beyond that level, you are really entering into a speculative investment and the rules of multiplication stop working well.

In order to justify the risk in this business, you would be willing to receive a return of between 20% and up to 40%. The multiplier at these levels will start to resemble what you might have been used to.  $100 \div 20 = 5$  down to  $100 \div 40 = 2.5$  respectively.

A business considered at the lower end of risk, based on all of the factors above will likely be at the higher end, say 5. If it is highly variable or has some systemic issues you may only be looking at a 2.5.

## THE GOOD NEWS

The really good news is that most of the things that influence the risk rating of your business are within your control. Those that aren't might be able to be managed either in the short, medium or long term. Once you are aware of how you rated yourself on all of the factors, you can take positive steps to increase your score and therefore increase the value of your business.

You have a line in the sand, say a multiplier of three. If you have an EBIT of \$100,000, your business benchmark value is \$300,000. However, if you can take steps that will decrease a future buyer's risk to say 3.5, then your business is now worth an additional \$50,000!



There is also the certainty that by focusing on systems and processes and management skills, or at least focusing on those areas that are in desperate need, your profits will go up as well.

In this example, after 12 months, your EBIT might be up to \$120,000 which at the new multiplier of 3.5 would mean a potential buyer would be willing to pay \$420,000; a massive gain of \$120,000!

## TAKING YOUR VALUATION TO THE BANK

The value in this methodology is that you can use your knowledge of accounting and business numbers to both increase the value of your business and earn more profits on a more consistent basis. But that doesn't mean that your valuation and assessment is the same as a pool of buyers. Many other factors might be working for or against you. This valuation is really your new internal benchmark for your own required rate of return on your business.

If you need a valuation for the bank or for investors or even when you are actually going to sell, it is a good idea to use the services of a licensed business valuer who knows your industry.

### RECAP

You need to know exactly where you are in order to measure your progress towards any goal.

In business, the best way you can do that is to make an honest assessment of what your company is worth.

After your initial assessment, make some adjustments and then measure again to ensure your adjustment has the impact you expected.

You can do your own valuation but it is a good idea to get your accountant to help you as they will take a less biased, outsider view.

**IT'S TIME TO DO A VALUATION OF YOUR BUSINESS. GET YOUR ACCOUNTANT TO HELP YOU WITH THIS.**



# CONCLUSION



You have now had a crash course in business finances. Even if your head is spinning a little, you are now a lot further ahead than most business owners. The most important takeaway from this book is the importance of having two things.

First, a basic understanding of accounting terminology as well as the key reports that you will need to succeed in the long term. Second, having a good accountant. With the right person on your side, you can work together to help your business stay in the black, prepare for the future and help you build a wonderful future for yourself and your employees.

If you had the feeling after reading this that your accountant isn't doing your business justice, it's time to find someone new. You may, on the other hand, feel like you owe your accountant an apology! Armed with so much new knowledge, you can now see the value they provide and come up with a new plan to become one of their A-class clients.

I hope this book helps you feel more confident about how to stay in control of your business and have many more meaningful conversations with your Accountant. Good luck and I wish you an exciting and prosperous future.

Scott Trevethan



# ABOUT THE AUTHOR

As well as being known as The Modern Accountant, Scott Trevethan is a small and medium sized business evangelist.

Ever since he read the E-Myth by Michael Gerber, Scott has been a passionate advocate for financial understanding as a way to ensure long-term security and success.

Born into an accounting family, Scott joined Deloitte straight from University and was engaged in the Audit and later the Insolvency division of that firm. It was in Audit he learned how large and successful businesses were built and operated. By stark contrast, Insolvency was where badly built businesses went to be buried, leaving despair and ruin in their path. Most were let down by poor record-keeping and general lack of financial astuteness.

Scott resolved to save as many Small and Medium sized businesses from insolvency as he could. This led to a passion for educating business owners and helping them to understand their finances so they could feel confident of a prosperous future.

Scott's professional career has spanned accounting firms, cafes and consulting. At the time of writing, he runs Financial Fanatics, a team of accountants and bookkeepers in the Philippines who provide Australian businesses with affordable and highly valuable services. For more information or to book a call with Scott, visit [www.financialfanatics.com](http://www.financialfanatics.com)

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