4 Pillars - Cash - Financial Health

To be able to sustainably grow your business in terms of revenue, margin and profit you need to align and effectively manage the four key business pillars of PEOPLE, PROCESS, EXECUTION AND CASH.

If you don't get this right you will be leaving money on the table and your results will suffer.

With this in mind I have created a critical 5 step process that falls under the CASH pillar This will help to improve your cash cycle and fund faster business growth.

Here are the 5 steps that should be part of your financial health checklist:

1. Determine your financial ratios

First things first, you need to have a point of comparison to determine whether your business is in good financial health. This can be done with the help of financial ratios. These are a set of calculations that use the financial information to determine the performance of a business.

There are 5 different kinds of ratios that help you determine a range of factors, including profitability, finance, and liquidity. By working out these figures, you can identify how well your business has performed in the previous months or years and you can more accurately judge how well your company has done compared to your competitors..

2. Review your cash flow

Small businesses are especially vulnerable to cash flow problems, so it's vital that you pay extra attention to this part of your business. Regularly review your monthly accounts. Are you earning enough revenue to cover all of your expenses? Can you pay your suppliers on time?

If you find that your expenses are too high, consider implementing creative strategies to reduce costs and save money. It's also a good idea to create a cash flow forecast looking out at least 3 months to help identify any potential issues.

3. Monitor sales invoicing and collection process

You need to be able to collect payments on time from your customers. If you know exactly how much money your customers owe you and you operate an efficient collections process, then your business is in the clear.

If you have problems collecting payments that are due from customers and you are spending a lot of time and energy on this task you may wish to consider engaging the services of a debt collections firm.

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4. Evaluate your sales & marketing pipeline

A quick review of your sales and marketing pipeline can tell you a lot about the financial health of your business. How many potential clients are currently on your list and how far along are they in the buying process?

Regularly reviewing your pipeline will give you a good idea of which direction your future sales are likely to go and what cashflows could look like. You can use this information to improve your products and services to keep ahead of your competition.

5. Perform a Strategic Thinking & Execution Planning Session (STEP)

Taking the financial temperature of your business does not only mean looking at the account, it also means reviewing and updating your business plan. This will allow you to pinpoint any issues or oversights that have negatively affected your company's financial health.

When performing a STEP session, ask questions like: Are your targets concerning sales revenue, profitability, and growth still valid? Have the needs of the market or customers changed? Are there any new opportunities you can take advantage of? The answers to these questions will help you adjust your targets so your business can be more productive moving forward.

There are many financial ratios you can use to assess the health of the business – but the ratios we have provided here are the main ones and are easy for you to use.

The ratios are grouped together under the key areas you should focus on.

Liquidity Ratios

Liquidity ratios assess your business' ability to pay its debts as they fall due – indicating the ease of turning assets into cash. In most cases, it's better to have higher ratios in this category -more current assets than current liabilities as an indication of sound business activities and an ability to withstand periods of pressure on cashflows.

Current ratio

$$\text{Current ratio} = \frac{\text{Total current assets}}{\text{Total current liabilities}}$$

As one of the most common measures of financial strength, this ratio measure whether the business has enough current assets to meet its due debts.

Generally, a current ratio of 2:1 is a good indicator, but this depends on the nature of the industry, and the form of its current assets and liabilities.

Quick ratio

$$\text{Quick ratio} = \frac{\text{Current assets – stock on hand}}{\text{Current liabilities}}$$

Also called the 'acid test ratio', this is one of the best measures of liquidity. By excluding stock which could take some time to turn into cash unless the price is reduced, it concentrates on real liquid assets.

It helps answer the question:

- If the business doesn't receive income for a period of time, can it meet its current obligations with the readily convertible 'quick' funds on hand?

Solvency ratios

Solvency ratios indicate the extent to which the business is able to meet all its debt obligations from sources other than cash flow.

It answers the question:

- If the business suffers from reduced cash flow, will it be able to continue to meet the debt and interest expense obligations from other sources?

Gearing ratio

$$\text{Gearing ratio} = \frac{\text{Total liabilities}}{\text{Equity}}$$

The gearing (or leveraging) ratio indicates the extent to which the business is reliant on debt financing versus equity to fund the assets of the business.

In most cases the higher the ratio, the more difficult it will be to obtain further borrowings.

Debt to assets

$$\text{Debt to assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

This measures the percentage of assets being financed by liabilities. In most cases, this ratio should be less than 1 – indicating adequacy of total assets to finance all debt.

Profitability ratios

These ratios will measure your business performance and ultimately indicate the level of success of your business operations.

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Comparing your net and gross margin calculations to those of other businesses within the same industry will provide you with comparative information, and potentially highlight possible scope for improvement in your margins.

The Australian Tax Office (ATO) provides an app to determine how your business compares to competitors in the same industry.

Gross margin ratio

$$\text{Gross margin ratio} = \frac{\text{Gross profit}}{\text{Total sales}}$$

This measures the percentage of sales dollars remaining after the direct cost of sales, available to pay the expenses of the business.

Net margin ratio

$$\text{Net margin ratio} = \frac{\text{Net profit}}{\text{Total sales}}$$

This measures the percentage of sales dollars remaining after all expenses.

Management ratios

Management ratios monitor how effectively you're managing your working capital, and determine:

- how quickly you're turning stock
- how often you're collecting monies outstanding from customers
- how often you're paying your suppliers.

These calculations provide an average that can be used to improve business performance..

Stock days

$$\text{Stock days} = \frac{\text{Average stock x 365}}{\text{Cost of goods sold}}$$

This ratio reveals how well your stock is being managed. It's important because it will indicate how long you're holding your stock for. In most cases, the less amount of time stock is held, the greater the profit.

Debtor days

$$\text{Debtor days} = \frac{\text{Debtors x 365}}{\text{Total sales}}$$

This ratio indicates how well the cash from customers is being collected – referred to as accounts receivable.

Creditor days

$$\text{Creditor days} = \frac{\text{Creditors x 365}}{\text{Purchases}}$$

This ratio indicates how well accounts payable are being managed. If payables are being paid on average before agreed payment terms and/or before debts are being collected, cash flow will be impacted.

Balance sheet ratios

These ratios will provide an indication of how effective your investment is in the business. The return on assets and investment ratios assess the efficiency of your business resources.

Return on assets

$$\text{Return on assets} = \frac{\text{Net profit before tax x 100}}{\text{Total assets}}$$

This measures how efficiently profits are being generated from the assets employed in the business.

Return on investment

$$\text{Return on investment} = \frac{\text{Net profit before tax x 100}}{\text{Equity}}$$

The return on investments is perhaps the most important ratio of all as it tells you whether or not all the effort put into the business is returning an appropriate return on the equity generated.

Regularly monitoring the above can help to pinpoint potential problem areas that need to be addressed so that the business operates effectively and efficiently.