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Using your financial statements to make informed business decisions

Whilst most small business owners do a reasonably good job of collecting information relating to their revenue streams, expenses and profits, many fail to use the tools at their disposal to forecast where the business is heading financially.

According to Dunn & Bradstreet's *Business Failures and Start-ups Analysis*, small businesses employing fewer than 20 staff record the highest rate of closure – more than twice the failure rate of larger companies. This indicates that many small business owners do not have an adequate understanding of business management fundamentals such as business planning and cashflow forecasting.

Being aware of the suite of financial reporting available to you could be the difference between healthy business growth and insolvency.

To understand the financial health of your business, we recommend that business owners use a range of short term and long term reporting tools.

Some reports such as Profit and Loss statements and Balance Sheets give you a historical picture of what has already happened, but can also be very helpful in identifying trends. Other fundamental management tools include cashflow forecasting, financial ratios and Key Performance Indicators (KPI's) which you can use to help you make strategic business decisions such as whether to increase or decrease fees, or whether to purchase plant, equipment or property.

The basic financial statements that businesses use to measure results in the short term include:

The Profit & Loss Statement (P&L)

The P&L provides a snapshot summary of income and expenses for the reporting period and includes:

- Revenue
- Fixed expenses
- Variable expenses
- Net profit (gross profit minus expenses)

At a minimum, we recommend that you review your P&L monthly.

The Balance Sheet

The balance sheet is a statement of assets, liabilities and owner's equity at a specified date. Assets include items such as cash, accounts receivable, equipment, inventory, land, buildings and investments. Liabilities are your financial obligations and include loans payable, accounts payable and taxes. You should ensure that are also aware of any potential liabilities that may affect your balance sheet in the future. These should be included in notes to the balance sheet. The main function of the balance sheet is to inform you of the working capital and leverage of the business.

The balance sheet should also be reviewed monthly.

Analysing the P&L and Balance Sheet

Once your P&L and balance sheet are up to date, you can start to apply financial ratios to analyse your performance, identify potential problems and to make informed business decisions. You can also use benchmarking and Key Performance Indicators (KPI's) to assess your results against past performance, budgets or similar businesses in your industry.

The types of ratios that you need to be familiar with include:

- Breakeven point – what level of patient fees do I need to cover all of my expenses?
- Net profit margin – am I maintaining or growing profitability?
- Expenses ratio – are my expenses in line with my budget?
- Return on Investment – is the return on the capital invested in the business worthwhile, with a view to the current economic climate?

However, it is not enough to simply monitor your historical performance or operate using short term budgets. Your business plan over the next five year period should also include:

Cashflow Forecasting and P & L Projections

When forecasting cashflow, you need to consider any relevant information that you are aware of that may impact on revenue or expenses. In the case of many dental practices, this may mean adjusting for changes to Medicare rebates or payments from fund providers.

On the expenses side, you also need to be aware of wider market trends for example, what is the average rate of wages growth in the current economic climate? Are interest rates likely to rise, fall or remain constant?

As forecasting is largely based upon assumptions, astute business owners ensure that they regularly review and update their projections to reflect the changing economic and business conditions.

Your P&L may be indicating a healthy profit – a positive sign that the business is able to operate within its boundaries. However it is important to know that a healthy profit outcome does not always indicate a healthy cash outcome. Cash can be affected by a number of variables including the time delay between completing the service and receiving the funds for that service, ie any increase in debtors will result in less cash. If you are seeing healthy profits but reducing cash, then it is a good time to consult your adviser and conduct a review.

If you find yourself in a situation where your revenue is falling and your expenses are rising, your break-even point can change dramatically and a position of profitability can rapidly become one of loss.

We recommend that you work with your accountant to identify the important financial ratios and KPI's that you should be monitoring, and to forecast your P & L and cashflow projections over the next one to five year period.

For dental practices where the revenue from health fund contracted providers is stagnating or even declining, monitoring these ratios is now of critical importance. Expenses continue to rise, therefore margins are shrinking. Practices will need to manage expenses very closely, whilst subsequently looking for opportunities to grow the business.

The content of this article is intended to provide a general overview and guide to the subject matter. If you would like to discuss your practice in more detail, please call Mark Kynaston at Smith Coffey on 9388 2833, or email at mark.kynaston@smithcoffey.com.au

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