Business evaluation guide

think+create

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Background

This guide to business evaluation is the first in a series of three guides. Once the evaluation process is complete, then business owners and managers need to focus on improving business performance in line with the recommendations from the evaluation. To assist in this next step, the second guide in the series provides practical approaches to improving business performance, covering both financial and non-financial aspects of business.

The third guide in the series is on dashboard reporting and provides examples of how the results of both business evaluation and improving business performance can be reported in a short-form format outlining the key drivers, the performance of these and any further actions or comments that will enhance business decision making.

Introduction

Evaluating the performance of any business is an essential practice to assist in early identification of potential problems and noting both positive and negative trends within business activities. By undertaking regular evaluations, the progress of the business activities will be clarified and owners, managers and advisers will have credible information that can be used to form the basis for planning for the successful growth of the business.

There is no standard template to evaluate a business. Each business will be unique in its own way and the key drivers for each business will vary. When undertaking an evaluation it is important to understand how the business operates, and what the key drivers are for the business as this will help develop a more structured and meaningful evaluation method. Appendix A provides a detailed case study of a business evaluation, Appendix B provides a suggested checklist and Appendix C provides a business evaluation template.

A business evaluation is most useful when you use current information. Nearly every business, regardless of size, will be required to complete financial compliance reporting of some type. For example, in Australia, all businesses registered for goods and services tax are required to complete a business activity statement for the Australian Taxation Office (ATO). By undertaking regular evaluations that align with reporting requirements, real benefits will materialise for owners and managers. Aligning frequent reporting with business evaluation provides sound empirical evidence on the operations of the business that allows owners and managers to become proactive in their decision-making processes within the business.

In order to provide a comprehensive and thorough evaluation of a business, the process should not be limited to a financial review. It is likely that many businesses will also have a number of key drivers that are non-financial (although likely to have a financial impact on business operations). Including an assessment of areas such as economic factors, competitive market influences, human resource issues and global events and trends, as well as any other non-financial drivers, will not only provide additional information on business operations, but may also support or explain the financial trends highlighted in the evaluation.

To assist in developing a business evaluation model, a case study has been included in the guide. This case study provides an overview of the key drivers of a retail plant nursery and how the business evaluation model has been developed (from reviewing historical financial data). It can be clearly seen in this case study that the analysis of financial data leads to further analysis of operational areas of the business.

This guide will help business owners, accountants and other business advisers implement a business evaluation method for their business (or their client’s business) that will be relevant and provide useful information on current operating performance and trends that can be utilised to improve the success of the business.

Before an evaluation begins

Assessing the business

When developing a method of business evaluation, it is important to assess each business individually. This can be achieved through a number of tactics, such as interviews with key personnel, reviews of policies and procedures and reviews of historical financial and other key data. The objective is to familiarise yourself with the business operations and the key drivers within the business. Some of the questions you may like to consider include:

- What is the overall objective (mission) of the business?
- Are there any qualitative issues within the business that are considered essential for the operations of the business?
- Have there been a history of financial issues, or other major problem areas, within the business?
- What is the experience of staff?
- What is the culture of the business?

Collecting the information

Once all relevant information regarding business operations and key drivers is obtained (including any additional information you believe relevant to the business in question that has not been mentioned previously), a review of key information should be conducted. This review could include an analysis of:

- the past three years of financial statements
- documented policies on key operational areas, such as mark-up and pricing, buying, stock management, internal controls, staffing and rostering and more
- the organisation chart and job descriptions
- compliance documents, such as bank loan agreements, leasing agreements and accreditation policies.

This list is not exhaustive.

Industry information

For advisers and managers developing and implementing a business evaluation method, another useful piece of information will be any information that can be obtained on the industry in which the business operates. This information can be both financial and industry-specific information. When utilising industry-specific information and comparing it to actual business results, the comparison will provide information on business performance that is measurable against other businesses within the same industry. Of course, this comparative analysis must be undertaken with caution, as there can be many variables between businesses within the same industry.

Industry-specific information is produced by a number of companies and other sources such as the Australian Bureau of Statistics, the ATO and small business government websites. If the business is a member of an industry association, the association may also have industry information that can be used in the evaluation.

Other considerations

There are two other issues that need to be considered when undertaking a business evaluation. Firstly, information from financial statements is historical. When analysing historical information, the analysis should be undertaken close to the preparation date to enhance the information's utility. Secondly, when using financial information it should be remembered that there are various accounting methods that can be applied to recording financial information. This in itself does not necessarily become an issue, however, when undertaking comparatives, the analyst should ensure that the data has been prepared on the same basis in order for the comparison to provide meaningful information.

Appendix B provides a checklist to assist in gathering relevant information to assist in the business evaluation.

Developing a business evaluation model

A starting point for evaluating a business is to review the past performance of a business by comparing historical financial results with the current financial statements from the business. This comparative analysis will provide information on trends, which is very helpful for planning the future progress of the business. The key to success of any business will be centred on five key areas that can impact business operations and financial outcomes. These are:

1. profitability
2. cashflow, liquidity and solvency
3. efficiency
4. business planning, both financial and operational
5. external issues and trends.

Of course each of these areas within the business will be interlinked. However, when developing the business evaluation model, it is preferable to separate each area so that the results of the analysis can be clarified prior to looking at any causal relationships within the results.

Profitability

It is very easy for profitability to be eroded if it is not measured and monitored on a regular basis. Therefore, it is important to understand how to use the tools available to continually evaluate the profitability of a business and understand the meaning of this information.

Cashflow, liquidity and solvency

Most businesses that fail do so because of a lack of available funding to manage ongoing operations. This is why regular monitoring of cashflow, liquidity and solvency is an important part of the business evaluation model. Monitoring these areas will include financial ratio analysis, cashflow forecasting and evaluation of funding sources.

Efficiency

Business owners will want to achieve the best possible return on their investment in a business. Regular monitoring of the efficiency of a business will ensure that the business is not only operating effectively, but that all assets are being utilised to generate the best rate of return for the investment.

Business planning

The most successful businesses will have strategic plans in place that align with the business objectives (or mission). These plans will be supported by budgets and forecasts that reflect the financial position of the business. All business evaluations should include a review of the alignment of the strategic plans to the budgets and forecasts. In addition, all good practice business planning will include development of policies for the key drivers of the business.

External issues and trends

Each business will be impacted by issues and trends that are external to the business. When developing a business evaluation model, it will be important to identify the key external issues that both directly and indirectly influence the business outcomes and undertake an assessment of each of these issues.

Business evaluation measures

Profitability measures

The ultimate success of any business will depend on profitability. One of the most important issues for any business is maintaining profitability. A profitable business will ensure that the business operations are in line with the overall strategic objective, whether it is to grow the business, sell at a later date, or any other objective.

Evaluating profitability can be undertaken by using profitability ratios, return ratios and using the mark-up and break even calculations. Some examples are shown below:

Gross profit margin	$\frac{\text{Gross profit}}{\text{Net sales}} \times 100$
Description	Gross profit margin is the percentage of sales dollars remaining to pay general expenses following the deduction of the cost of goods sold. Cost of goods sold can include direct costs such as materials/merchandise costs, carriage inwards on these, processing costs and production overheads.
Use	Analysis of this margin will assist in assessing the efficiency of the business, including the efficiency of pricing, stock purchasing procedures and handling. Well-designed and executed processes keep costs low and increase the gross margin.

Mark-up	$\frac{\text{Gross profit}}{\text{Cost of goods sold}} \times 100$
Description	Mark-up is the percentage difference between the actual cost and the selling price.
Use	It is generally only a meaningful figure when referring to the sale of products rather than services. It can be useful to use mark-up calculation to ensure you set the selling price at a level that covers all costs incurred with the sale.

Earnings before interest and tax (EBIT) margin	$\frac{\text{Net profit before interest and tax}}{\text{Net sales}} \times 100$
Description	This EBIT margin is the percentage of sales dollars left after deducting the cost of goods sold and all expenses, except income taxes.
Use	This measure enables the business to accurately compare the profit results with other businesses in the same or similar industries. Interest and tax are excluded as tax and interest can vary for each business. The analysis will provide information on the return on sales of the business. This ratio is often quoted by analysts reviewing the performance of a business compared to other businesses in the industry.

Net profit margin	$\frac{\text{Net profit}}{\text{Total income}} \times 100$
Description	The net profit margin is calculated after tax and interest and includes any other non-trading income.
Use	This measure should be used to compare the overall results of the business against other time periods. In deciding which periods should be used in the comparison, the type of business should be considered. For example, when analysing a seasonal business, such as a snow skiing equipment store, it would be more useful to compare the winter season of the current year with the winter season of the previous year rather than comparing the previous month with the current month.

Break even analysis	$\dfrac{\text{Fixed expenses}}{\text{1 less (cost of goods sold)/(net sales)}}$
Description	The break even calculation shows how many sales have to be made in dollars before all the expenses are covered and actual profit begins.
Use	This measure provides information on the correlation between sales, volume and price. It is particularly useful for setting sales targets for the business or for sales employees. Once the break even figure is known, then the business can monitor sales to ensure that all expenses for the period will be covered.

Cashflow, liquidity and solvency measures

Cashflow, liquidity and solvency should be monitored regularly to ensure the ongoing survival, both short-term and long-term, of any business. Liquidity is a measure of the ability of the business to meet short-term debt obligations while solvency measures the ability of the business to meet longer term commitments. Cashflow is an operational measure that ensures that the business has adequate cash to cover all outgoings during the period to be monitored.

Some examples are shown below:

Cashflow forecast	The cashflow forecast is obtained by calculating opening bank balances plus all receipts for the period less all payments for the period. The period can be as short as weekly, however more commonly a cashflow forecast period is by month. For businesses experiencing cash flow difficulty, it is recommended that forecasting is done more regularly than what is usual for the business. Appendix A provides an example of a cashflow forecast.
Description	A cashflow forecast is a very important tool for business as it provides information on future cash resources and how they will be applied to the business operations. Cashflow forecasting is an integral part of business planning and indicates any additional funding needs of the business in advance (so that the business can address such potential gaps).
Use	The forecast will predict the ability of your business to create the cash necessary for expansion or to support the operations of the business. It will also indicate any cashflow gaps the business may experience – periods when cash outflows exceed cash inflows.

Working capital to total sales	$\dfrac{\text{Total current assets less total current liabilities}}{\text{Total sales}}$
Description	Working capital to total sales provides an indication of how much working capital per dollar of sales the business should be holding.
Use	Analysis of this ratio must take into account the type of trading the business is undertaking to provide any meaningful interpretation. For example, a business that sells a lot of low-cost items and cycles through stock quickly (such as a cafe) may only need 10%-15% of working capital per dollar of sales. A manufacturer of heavy machinery and high-priced items with a slower stock turnaround may require 20%-25% working capital per dollar of sales.

Current ratio	$\frac{\text{Total current assets}}{\text{Total current liabilities}}$
Description	One of the most common measures of financial strength, current ratio measures whether the business has enough current assets to meet its due debts with a margin of safety.
Use	A generally acceptable current ratio is 2:1; however, this will depend on the nature of the industry and the form of its current assets and liabilities. For example, the business may have current assets made up predominantly of cash and would therefore survive with a relatively lower ratio.

Quick (acid) ratio	$\frac{\text{Total current assets less stock on hand}}{\text{Total current liabilities less bank overdraft}}$
Description	Quick (acid) ratio is one of the best measures of liquidity. By excluding inventories, which could take some time to turn into cash unless the price is discounted, this calculation concentrates on real, liquid assets.
Use	It helps answer the question: If the business does not receive income for a period, can it meet its current obligations with the readily convertible “quick” funds on hand?

Leverage (gearing) ratio	$\frac{\text{Total liabilities}}{\text{Total equity}} \text{ X } 100$
Description	The leverage (gearing) ratio indicates the extent to which the business is reliant on debt financing versus equity to fund the assets of the business. This ratio is heavily used by lenders in banking covenants, therefore another reason to monitor this ratio is to ensure the business does not breach bank covenants.
Use	Generally speaking, the higher the ratio, the more difficult it will be to obtain further borrowings.

Debt to asset ratio	$\frac{\text{Total liabilities}}{\text{Total assets}} \text{ X } 100$
Description	The debt to asset ratio measures the percentage of assets being financed by liabilities.
Use	Generally speaking, this ratio should be less than 1, indicating adequacy of total assets to finance all debt.

Evaluation of funding sources	You can evaluate funding sources by reviewing all loan documentation and finance facilities (such as overdrafts), including leases, hire purchase and debtor finance, and ensure that each finance facility is readily available when required. Areas of review should include loan terms and conditions and financial covenants and reporting compliance requirements.
Description	It is critical to evaluate funding sources in an evaluation on solvency in order to ensure that the business has adequate access to funding sources when required.
Use	The evaluation of funding sources can be used in conjunction with the financial ratios for cashflow, liquidity and solvency and will be particularly useful when reviewing cashflow forecasts and identifying cashflow gaps.

Efficiency measures

To ensure that the business is effectively utilising and controlling both the assets and liabilities within the business, there are a number of measures that can be reviewed. Some examples are shown below.

Stock turnover	$\dfrac{\text{Cost of goods sold}}{\text{Average stock held for the period}}$
Description	The stock turnover rate indicates the number of times the stock in the business has turned over.
Use	The lower the rate, the longer the stock is taking to turn over. This can provide an indication of issues with stock management, such as aged or excess stock holding. Funds that are invested in stock for longer periods can have an adverse effect on liquidity.

Total stock on hand to total assets	$\dfrac{\text{Total stock on hand}}{\text{Total assets}} \text{ X } 100$
Description	The total stock on hand to total assets ratio measures percentage of stock on hand included in the overall assets of the business.
Use	If a high percentage of a business's assets are tied up in stock and it does not have a relatively high turnover rate (a high turnover rate would be less than 30 days), it may be a signal that something is wrong and there could be potential for a stock write-down/off.

Debtor's days	$\dfrac{\text{Total debtors X number of days in the analysis period}}{\text{Total credit sales for the number of days in the analysis period}}$
Description	The debtor's days ratio indicates how promptly accounts from customers are being collected.
Use	When comparing the results of this calculation to the trade terms offered to customers, this will indicate slow paying customers as well as potential bad debts. The ratio is most useful when used in conjunction with an aged debtor's report.

Aged debtor's report	
Description	The aged debtor's report is generated by a financial system that lists all outstanding customer payments by number of days. The list usually provides outstanding payments by current, 30 days, 60 days, 90 days and over.
Use	This report is particularly useful when used with the debtor's days calculation noted above. It will provide information on all outstanding customer accounts and can be used to chase up late payments and identify potential problem customer accounts.

Creditor's days	$\dfrac{\text{Total creditors X number of days in the analysis period}}{\text{Total cost of goods sold for the analysis period}}$
Description	The creditor's days ratio indicates how well accounts payable are being managed.
Use	When comparing the results of this calculation to the trade terms offered by suppliers, the results will provide information on supplier payments. If the analysis highlights that creditors are being paid on average before agreed payment terms cashflow can, potentially, be impacted. If payments to suppliers are excessively slow, there is a possibility that the supplier relationships will be damaged.

Aged creditor's report	
Description	The aged creditor's report is generated by a financial system that lists all outstanding payments to suppliers by number of days. The list usually provides outstanding payments by current, 30 days, 60 days, 90 days and over.
Use	This report is particularly useful when used with the creditor's days calculation noted above. It will provide information on all outstanding supplier accounts and can assist when preparing forecasted cash payments.

Total asset turnover	$\frac{\text{Net sales}}{\text{Total assets}}$
Description	The total asset turnover measures the ability of a business to use its assets to generate sales.
Use	The lower the total asset turnover ratio, as compared to historical data for the business and industry data, the more sluggish the business sales are. This may indicate a problem with one or more of the asset categories composing total assets – stock, debtors or fixed assets. Each asset class should be reviewed to determine where the problem lies.

Return on assets (ROA)	$\frac{\text{Net profit before tax}}{\text{Total assets}} \times 100$
Description	The return on assets measure indicates how efficiently profits are being generated from the assets employed in the business when compared with the ratios of businesses in a similar business.
Use	The ratio will only have meaning when compared with the ratios of others in similar organisations. A low ratio in comparison with industry averages indicates an inefficient use of business assets.

Return on equity/ investment (ROI)	$\frac{\text{Net profit before tax}}{\text{Total equity}} \times 100$
Description	The return on the business owner's investment (ROI) is perhaps the most important ratio of all as it tells you whether or not all the effort put into the business is, in addition to achieving the strategic objective, returning an appropriate return on investment.
Use	If the ROI is less than the rate of return on an alternative, low risk or risk-free investment, such as a term deposit, this raises the question of the overall investment in this business. A high ROI means that investment compares favourably to investment costs.

Total sales to number of sales employees	$\frac{\text{Total sales}}{\text{Number of sales employees}}$
Description	The total sales to the number of sales employees provides the average dollar value of sales made for each employee directly associated with the sales function for the analysis period.
Use	Although this measure will only provide the average value of sales per employee, it is helpful in identifying trends in the average dollar value of sales per sales employee.

Employee sales	Total value of sales made by each employee for the analysis period.
Description	The employee sales measure is useful to review productivity of each employee.
Use	Although this measure will only provide the total value of sales per employee, it is helpful in determining how productive the business is in generating sales.

Business planning

The most successful businesses will have strategic plans in place that align to the business objectives (or mission). These plans will be supported by budgets and forecasts that reflect the financial position of the business and take into consideration these plans. All business evaluations should include regular review of the alignment of the budgets and forecasts with strategic plans.

Both budgeting and forecasting are critical tools that a business should use to assist in planning for the future success of the business. When undertaking the evaluation, a business should review both of these tools and the overall strategic plans to ensure that the current business operations are on track to achieve the business objectives. The areas of review should include (but is not limited to):

- the frequency of the preparation of a strategic plan, budget and forecasts
- where the information for the budgeting and forecasting tools is being sourced, i.e. which business units
- the assumptions that have been used in developing the budgeting and forecasting plans, including credibility and validity of the bases of the assumptions
- the authorisation process for the development of budgeting and forecasting, such as whether the forecasts are approved by the owner or board
- which reporting mechanisms are in place for review of strategic plans, budgets and forecasts.

To support strategic plans and ensure they are followed and achieved, a business should consider implementing policies for the key drivers of the business. Policies will provide guidance on procedures that will support the direction of the business objectives. Examples of key policies could include (but are not limited to):

- mark-up policies
- discount policies
- expenditure policies (such as travel policy, vehicle policy, personnel policies)
- authorisation policies (such as budget approval policy)
- internal control policies (such as staff sales processing policy).

External issues and trends

To complete the business evaluation, an assessment of factors that can impact the business, but for which the business has little or no control over, should be undertaken. For each business, these factors and the possible implications for the business will vary. Therefore, it is impossible to provide a comprehensive listing of external issues and trends. However, the following list helps identify key external factors that could be included in the business evaluation:

- economic factors, such as foreign exchange rates, interest rates, commodity price, inflation rates, growth rates and unemployment rates
- political factors, such as government policy, fiscal and monetary policy, current and proposed legislation
- global factors, such as free trade agreements and international tariffs
- industry issues such as accreditation and a code of conduct
- environmental issues, such as droughts, floods and climate change
- markets, such as the global, domestic and industry-specific markets.

Conclusion

Business evaluation should be undertaken by every business owner and manager. The overall performance of a business should be monitored on a regular basis to ensure the business is on track to achieve the overall objectives in a financially sound manner. A simple way of implementing business evaluation is to match this process with the reporting cycles of the business.

There are many different tools that can be used to evaluate the performance of a business and the most beneficial technique is to use the tools that are relevant and individually suited to the operations being analysed. Identifying the key drivers that impact business operations will be important in developing the business evaluation model and matching the relevant measures to these key drivers.

It is important to note that any stand-alone information will not be highly meaningful. What will be beneficial is to undertake regular business evaluations that can be compared to information obtained from previous evaluations so that trends and potential problems and opportunities can be detected and acted upon. With regular appraisal of business operations through structured business evaluation models, the business is most likely to achieve both efficient and effective business operations that will ultimately lead to business success.

Implementing an evaluation model suited to the operations of the business will ensure that there is a process in place to identify potential problems and opportunities and monitor the changing environment in which the business operates, providing information for the business to successfully evolve and achieve its overall objectives.

Appendix A: Business evaluation case study

To assist in developing a model for evaluating a business, the following case study is provided as a guide. As mentioned previously, each business will be unique in its own way and the impact of business drivers for each business will vary, therefore this case study should only be used as reference to developing your own business evaluation model.

Bundalong retail plant nursery

Bundalong retail plant nursery is situated in a rural town which has a population of approximately 38,000 residents. The nursery has been operating for 15 years and in the past few years has been recording operational losses. The business evaluation was undertaken in July of the current year.

The business evaluation for this case study involves a review of the financial information against the benchmark information together with a review of documentation provided and physical procedures noted during site visits.

Financial statements

Profit and loss statement for year ended July

	Current year ($)		Previous year ($)	
Sales	438,707.15		345,314.93	
Cost of goods sold				
Opening stock	119,979.00		71,573.65	
Purchases	224,938.00		214,050.11	
	344,917.00		285,623.76	
Closing stock	(96,490.49)		(119,979.00)	
Total cost of goods sold	248,426.51	56.63%	165,644.76	47.97%
Gross profit	190,280.64	43.37%	179,670.17	52.03%
Operating expenses				
Salaries	(233,294.80)	53.18%	(200,236.01)	57.99%
Overheads	(85,903.42)	19.58%	(96,691.18)	28.00%
Total operating expenses	(319,198.22)	72.76%	(296,927.19)	85.99%
Net loss	(128,917.58)		(117,257.02)	

Average stock held for each year	$ 108,234.75	$ 95,776.33

Areas noted for further review from figures above include stock holdings and salaries.

Breakdown of operating expenses

Operating expenses	Current year		Previous year	
	$	% of expense*	$	% of expense*
Cleaning contract	1,740.00	2.03	1,160.00	1.20
Repairs and maintenance				
Buildings	794.26	0.92	656.39	0.68
Equipment	978.22	1.14	859.64	0.89
Furniture and fittings	1,702.80	1.98	1,626.81	1.68
Grounds	4,656.30	5.42	9,646.20	9.98
Electricity	2,821.48	3.28	2,729.10	2.82
Vehicles				
Fuel	3,220.07	3.75	2,578.55	2.67
Registration	355.00	0.41	352.20	0.36
Insurance	1,250.00	1.46	1,200.00	1.24
Repairs and maintenance	1,712.51	1.99	1,872.71	1.94
Transport – contract	—	—	460.04	0.48
Depreciation				
Equipment	5,152.84	6.00	5,421.84	5.61
Furniture and fittings	4,324.41	5.03	4,961.39	5.13
Motor vehicles	6,392.29	7.44	6,577.53	6.80
Advertising	14,515.12	16.90	15,954.60	16.50
Uniform costs	277.89	0.32	451.54	0.47
Printing and stationery	1,017.50	1.18	892.62	0.92
Telephone	2,655.50	3.09	2,960.61	3.06
Staff provisions	1,431.55	1.67	1,665.49	1.72
Rent	22,455.00	26.14	19,525.00	20.19
Equipment	620.00	0.72	1,222.22	1.26
Staff training	310.09	0.36	438.18	0.45
Travelling	191.07	0.22	76.63	0.08
Materials and supplies	529.48	0.62	581.65	0.60
Bank charges	3,013.19	3.51	2,809.30	2.91
Memberships and subscriptions	579.32	0.67	520.00	0.54
Health and safety	259.30	0.30	117.79	0.12
Postage	364.70	0.42	369.44	0.38
Computers	—	—	4,504.14	4.66
Sundry administration costs	2,583.53	3.01	1,681.39	1.74
Consultancy fees	—	—	2,818.18	2.91
Total operating expenses	85,903.42		96,691.18	

* Figures rounded to the nearest hundredth.

Areas noted for further review from figures above include decrease in ground maintenance expense, increases in rent bank charges and why there is no computer expense for the current year (i.e. is technology not up to date?).

Balance sheet

	Current year ($)	Prior year ($)
Assets		
Current assets		
Cash/bank	16,320.00	65,777.82
Debtors	14,280.00	32,000.00
Stock	96,490.00	119,979.00
Other	4,210.00	5,500.00
Total current assets	**131,300.00**	**223,256.82**
Non-current assets		
Delivery vehicle	75,000.00	75,000.00
Less accumulated depreciation	(19,547.35)	(12,969.82)
Total	55,452.65	62,030.18
Nursery fit out	115,000.00	115,000.00
Less accumulated depreciation	(66,955.45)	(61,994.06)
	48,044.55	53,005.94
Equipment	50,000.00	50,000.00
Less accumulated depreciation	(41,021.20)	(35,599.36)
	8,978.80	14,400.64
Total non-current assets	112,476.00	129,436.76
Total assets	**243,776.00**	**352,693.58**
Liabilities		
Current liabilities		
Creditors	65,000.00	48,000.00
Credit card	15,000.00	12,000.00
Total current liabilities	**80,000.00**	**60,000.00**
Non-current liabilities		
Bank loan	20,000.00	20,000.00
Total liabilities	**100,000.00**	**80,000.00**
Equity		
Shareholders' funds (including retained earnings, losses)	272,693.58	389,950.60
Less current year accumulated losses	(128,917.58)	(117,257.02)
Total equity	**143,776.00**	**272,693.58**

Operational activities

Staffing

Full-time equivalent 5.30, including:

- Owner/manager 1.30
- Apprentice 1.00
- 6 Part-time 3.00

Part-time duties include:

- General sales, orders, quotes 0.80
- General sales, admin 0.60
- General sales, buying 0.60
- General sales 0.60
- 2 staff general sales (2 x 0.20) 0.40

Trading hours: 59.50 hours per week, 8.30am to 5.00pm every day except Christmas Day, Good Friday, Easter Sunday and the morning of Anzac Day.

Documentation reviewed

Mark-up policy: The standard mark-up policy is 110 per cent.

Buying policy: No formal buying policy held.

Job descriptions: No formal job descriptions held.

Discount/VIP policy: The discount policy notes the following:

Discount	Category
2.5%	Non-VIP members
10%	VIP members
	Schools
	Businesses
	Garden design customers
15%	Landscapers value to $200
20%	Landscapers value $201 to $500
	TAFE and other colleges
25%	Landscapers value more than $500
	Nursery staff

Financial benchmarks

As provided by Bundalong retail plant nursery from their industry association.

Financial benchmarks	
Total average income	**$ 446,556**
Cost of goods sold	48.99%
Gross margin	51.01%
Selected overheads as percentage of income	
Advertising and promotion	2.26%
Salaries and wages including staff on costs	13.77%
Vehicle operating costs	3.74%
Rent	3.32%
Bank charges	1.53%
Total overheads	**37.25%**
Net profit margin	13.76%
Personnel numbers (FTE)	
Working owners	1.52
Sales staff and nursery people	2.36
Any other staff	0.49
Total personnel	**4.37**
Other benchmark information	
Stock turn rate	3.50
Plants grown in house as percentage of total sales	20.00%
Trading hours per week	54
Percentage of sales made to account customers	25.00%

Analysis of Bundalong retail nursery financial information in comparison to the benchmark in current and previous year

	Industry benchmark	Current year	Variance of current year to benchmark	Variance of current to previous year	Previous year	Variance of previous year to benchmark
Total income	$446,556.00	$438,707.15	($7,848.85)	$93,392.22	$345,314.93	($101,241.07)
Cost of goods sold	48.99%	56.63%	7.64%	8.66%	47.97%	(1.02%)
Gross margin	51.01%	43.37%	(7.64%)	(8.66%)	52.03%	1.02%
Selected overheads as a percentage of income						
Advertising and promotion	2.26%	16.90%	14.64%	0.40%	16.50%	14.00%
Salaries including staff on costs	13.77%	53.18%	39.41%	(4.81%)	57.99%	44.22%
Vehicle operating costs	3.74%	7.61%	3.87%	1.40%	6.21%	2.47%
Rent	3.32%	26.14%	22.82%	5.95%	20.19%	16.87%
Bank charges	1.53%	3.51%	1.98%	0.60%	2.91%	1.38%
Total overheads	37.25%	72.76%	35.75%	(13.00%)	85.99%	48.75%
Net profit margin	13.76%	(29.39%)	(43.15%)	4.57%	(33.96%)	(47.72%)
Personnel numbers (FTE)						
Working owners	1.52	1.30	(0.22)	0	1.30	(0.22)
Sales staff and nursery people	2.36	4.00	1.64	0.50	3.50	1.14
Any other staff	0.49	0	(0.49)	0	0	(0.49)
Total personnel	4.37	5.30	0.93	0.50	4.80	0.43
Other benchmark information						
Stock turn rate	3.50	2.30	(1.20)	0.57	1.73	(1.77)
Plants grown in house as a percentage of total sales	20.00%	22.00%	2.00%	2.00%	20.00%	0
Trading hours per week	54	59.50	5.50	0	59.50	5.50
Percentage of sales made to account customers	25.00%	58.00%	33.00%	3.00%	55.00%	30.00%

Commentary on industry benchmark variances

Total income	The total income in the current year is up from the previous year and is within 5% of industry benchmark.
Cost of goods sold	Total cost of goods sold for the current year is 8.66% higher than the previous year and 7.64% higher than the benchmark. Recommend further investigation.
Gross margin	Gross margin variances in line with cost of goods sold variances noted above. Review cost of goods sold.
Selected overheads as percentage of income	
Advertising and promotion	Current year expense up slightly from previous year. This expense for current year and previous year are substantially higher than benchmark. Recommend further investigation.
Salaries including staff on costs	Current year expense lower than previous year, although increase in staff numbers (see FTE data below). However, figures are still substantially higher than benchmark. Recommend further investigation.
Vehicle operating costs	This expense for both current and previous year are higher than the benchmark. Recommend further investigation.
Total overheads	Current year expenses lower than previous year, however substantially higher than benchmark most likely due to high salary overheads. Recommend further investigation.
Net profit margin	Net operating loss reported for both current and previous year due to key areas noted above.
Personnel numbers (FTE)	
Working owners	The working owner data suggests that the Bundalong owner is working slightly below benchmark.
Sales and nursery staff	The current year staffing is higher than previous year (although overall salaries are lower) and also higher than benchmark data. Recommend further investigation.
Any other staff	
Total personnel	
Other benchmark information	
Stock turn rate	The current year stock turn rate is higher than the previous year, however, both figures are well below benchmark. Further investigation recommended.
Plants grown in house as percentage of total sales	The current year plants grown in house is higher than benchmark. Further investigation recommended.
Trading hours per week	Total trading hours remained constant for both current and previous year, and slightly higher than the benchmark.
Percentage of sales made to account customers	The percentage of sales made on account increased slightly in current year compared to previous year, however for both years this percentage is substantially higher than industry benchmarks. Given these sales are on discount, it means that most sales are below the mark-up stated in the mark-up policy. Further investigation recommended.

Bundalong profitability measures

	Gross profit margin	Mark-up	Earnings before interest and tax (EBIT) margin	Net profit margin
Current year	43.37%	76.58%	(29.39%)	Same as EBIT – no tax paid due to recorded loss
Previous year	52.03%	108.46%	(33.96%)	
Variance	(8.66%)	(31.88%)	(4.57%)	

Bundalong cashflow, liquidity and solvency measures

	Cashflow forecast	Current ratio	Quick (acid) ratio	Leverage	Debt to asset
Current year	No cashflow forecast recorded	1.64	0.54	69.55%	41.02%
Previous year		3.72	2.15	29.37%	22.68%
Variance		2.08	1.61	40.18%	18.34%

Bundalong efficiency measures

	Stock turnover	Total stock on hand to total assets	Debtors' average days outstanding	Creditors' average days outstanding	Total asset turnover	Return on assets (ROA)	Return on equity (ROI)	Total sales to sales employees
Current year	2.30	39.58%	21	58	1.79	Nil	Nil	$109,676
Previous year	1.73	34.02%	58	182	0.98	Nil	Nil	$98,661
Variance	0.57	5.56%	(37)	(124)	0.81			$ 11,015

Employee sales refer to detailed commentary on analysis.

Detailed commentary of analysis

Bundalong profitability measures

Gross margin for current year has decreased by 8.66 per cent from the previous year and 7.64 per cent below benchmark data. Given that there has been a substantial increase in sales, it appears that this reduction will be due to stock issues.

The stock turn rate provides some indication of stock issues, with the current year rate approximately 33 per cent below benchmark. When considering a retail nursery, stock will be bought to sell according to season in addition to a standard "year round" core level of stock. The benchmark data appears to reflect this at 3.50; with four seasons in the year, so stock turn is slightly lower reflecting the holding of both seasonal and core level stock.

Taking into account the variance in stock turn to benchmark and the decrease in mark up from 108.46 per cent in the previous year, which was in line with mark-up policy of 110 per cent to 76.58 per cent for the current year, further investigation was undertaken. This further investigation provided the following information:

- Although the mark-up on stock was adjusted twice during the current year to reflect higher purchase price of goods, further analysis into the decrease in gross margin highlighted an increase in freight charges. On some occasions, freight charges were as high as $1.00 per freighted plant. Total freight and potting charges (add on costs) amount to $17,001.00, approximately 7 per cent of total cost of goods sold during current year. These charges had not been accounted for in the mark-up calculation and account for the majority of the decrease in gross margin. These increasing costs were confirmed by the retail nursery association as an industry experience in the last 12 months.
- Included in the cost of goods sold is the amount of stock "written off" during the year. This is recorded as "destroyed stock" and unaccounted losses realised at stocktake. The current procedure for "destroying" stock is that any staff member can identify stock which is dead or not in a saleable form at any time. The owner has advised that at one stage this procedure had to be approved by the owner, however this is not currently being adhered to. To record destroyed stock, the item is sold to the "destroyed stock" account on the register and the plant and pot is disposed of. At the end of each month, the closing stock balance is adjusted to reflect the lost stock. There is currently no review of destroyed stock, either physical or on regular reports. There is a brief reference to destroyed stock in the general procedures and instructions on how to record destroyed stock in the computer procedures. Further analysis of destroyed stock found that 15 per cent of all destroyed stock was recorded on weekends, when there is no management supervision.
- Following the current year stocktake, records show that a further $16,523 of stock was missing from the physical count, representing 6.65 per cent of the total cost of goods sold. The closing stock balance for the current year was reduced by this amount to record the shrinkage.
- Taking account of the destroyed stock and stock losses realised during the current year stocktake, the total shrinkage to stock at cost price amounted to $28,813, 11.65 per cent of total cost of goods sold and 27 per cent of the average stock holdings for the current year. Consultation with the industry association indicated that destroyed stock should average approximately $4000 (at cost) per annum based on the total sales of Bundalong. Therefore destroyed and stock losses are in excess of industry standards.
- An adjusted profit and loss statement "adding back" destroyed and written off stock provides the following result:

	Current year ($)		With stock adjustments ($)	
Sales	438,707.15		438,707.15	
Cost of goods sold				
Opening stock	119,979.00		119,979.00	
Purchases	224,938.00		224,938.00	
	344,917.00		344,917.00	
Closing stock	(96,490.49)		(125,303.49)	(including stock adjustment)
Total cost of goods sold	248,426.51	56.63%	219,613.51	50.06%
Gross profit	**190,280.64**	**43.37%**	**219,093.64**	**49.94%**
Operating expenses				
Salaries	(233,294.80)	53.18%	(233,294.80)	
Overheads	(85,903.42)	19.58%	(85,903.42)	
Total operating expenses	**(319,198.22)**	**72.76%**	**(319,198.22)**	
Net profit/loss	**(128,917.58)**		**(100,104.58)**	
Mark-up	76.59%		99.76%	
Stock turn	2.30		1.79	

- The average stock holdings for current year was $122,641.35 (including stock losses from destroyed stock and shrinkage). The average level of stock holdings required to meet benchmark stock turn, where cost of goods remain the same, is $63,007.73. A physical analysis on aged stock was undertaken by the owner (currently the stock management software system does not allow for specific data on aged stock). Aged stock (held for more than six months) was estimated at approximately $31,783.86. In the event that the aged stock had been sold, the average stock levels would decrease to $90,857.49 (2.41 turns), bringing this closer to the average stock levels required to achieve benchmark stock turn.
- Low stock turn rate can lead to higher probability of destroyed stock and/or increased resources to manage stock. Where stock turn is low, the ability to purchase new stock will be impacted due to constraint in space and maintaining acceptable stock levels. This in turn could result in lower sales due to high levels of aged stock held and lower than acceptable levels of “fresh” stock.
- No formal buying procedure is documented. Currently, stock purchases are decided through discussions with staff. Details of stock movement, such as stock at low levels, high turnover and plants that customers are requesting is provided by staff. This, together with seasonal requirements, will then form the basis for purchase. The informal nature of the buying procedure could account for the high level of stock holdings, excess stock and hence destroyed stock. A formal buying policy would include analysis of current value of stock holdings to ensure that stock turn and average stock holdings are in line with agreed benchmarks.
- Given the level of information held in the current stock management system, it is possible that this data can be used to assist in the buying procedures. Information on high volume of sales of certain stock items, stock held past a certain time frame and low levels of stock items should form part of the formal buying procedures.

Key recommendations

1. Reduce average stock levels.
2. Monitor and manage ageing stock.
3. Implement policy for destroying stock.
4. Regularly monitor mark-up to ensure all costs are covered in selling price.
5. Develop and implement a formal buying procedure.

Bundalong sales analysis

Total sales for current year increased by 27.05% to $438,707.15, compared to previous year total sales of $345,314.93, an increase of $93,392.22.

Detailed analysis of sales records (point of sale) provided the following information:

- Thirty-six per cent of all sales were achieved in three trading months, December, September and August of the current year. The analysis also indicated that approximately 30 per cent of sales were achieved in the slowest five months for the current year.
- An analysis of the overall sales as a percentage achieved for each day of the week highlighted that trading on Saturday and Sunday generated 36 per cent of total sales (public holidays have been included in the trading figures for Sunday). The review noted that for the majority of weekends and public holidays, staffing levels were two full-time equivalents (FTE) with no supervision from the owner.
- The official trading hours for the retail operation is 59.50 hours per week (8.30am to 5.00pm, including weekends). When compared to the benchmark data, this is the highest number of trading hours, however it is within an acceptable range.
- The sales records also provided information showing that 86.44 per cent of overall sales (on average) are completed after 11.00am each day.
- The total amount of discount applied during the current year was $41,158 (9.38% of total income). No comparison to the previous year was conducted as discount amounts were not separately recorded for that year.
- Two competitors were "mystery shopped" to ascertain the discount policies they offer. It appears that Bundalong discount policy is extremely generous. In particular, with 58 per cent of sales made to account customers (landscapers and other larger organisations) and the same customers receiving the most beneficial discounts, it is evident that the discounting policy is having a significant impact of total income.

The profit and loss statement reflecting “add backs” of discounting and destroyed and unaccounted for stock losses provides the following result:

	Current year ($)		With stock adjustments and discounts removed ($)	
Sales	438,707.15		479,865.15	
Cost of goods sold				
Opening stock	119,979.00		119,979.00	
Purchases	224,938.00		224,938.00	
	344,917.00		344,917.00	
Closing stock	(96,490.49)		(125,303.49)	
Total cost of goods sold	248,426.51	56.63%	219,613.51	45.77%
Gross profit	190,280.64	43.37%	260,251.64	54.23%
Operating expenses				
Salaries	(233,294.80)	53.18%	(233,294.80)	48.62%
Overheads	(85,903.42)	19.58%	(85,903.42)	17.90%
Total operating expenses	(319,198.22)	72.76%	(319,198.22)	66.52%
Net profit/loss	(128,917.58)		(58,946.58)	

Key recommendations

1. Record discounts separately in profit and loss statement against sales.
2. Amend discount policy.
3. Review pricing structure including mark-up policy.
4. Review staff roster for weekends to maximise sales potential.
5. Review trading hours/staffing levels.

Bundalong overhead expenses

The key area of concern in overhead expenses relates to salaries. Salary expense for the current year was $233,294.80 (53.18 per cent of sales) compared to $200,236.01 (57.99 per cent) in the previous year and the industry benchmark of 13.77 per cent. The benchmark data indicates a range of percentages for salaries and salary on costs. During discussions with the retail nursery association, they indicated that they were unsure how accurate this percentage in the benchmark data was and that they believed that salaries within the industry are on average, 20 to 25 per cent of sales.

At 53.18 per cent of income, the salary expenses are extremely high. Further review in the areas of productivity and staff rostering was undertaken and provided the following observations:

- The full-time equivalent benchmark data indicates, for the non-metro area and total income level achieved by Bundalong, there is 5.3 FTE to benchmark data of 4.2 FTE (including working owner benchmark of 1.53 compared to Bundalong of 1.30).
- Given the above information, staff productivity was reviewed from the point of sale system. The staff productivity calculation (sales to hours paid) was:

Full current year	$39.10 sales per hour paid
July to December (last year)	$46.33 sales per hour paid
January to June (this year)	$31.90 sales per hour paid

This indicates that during the first half of this year, productivity has dropped.

- A review of the annual sales percentage per day and number of rostered staff clearly showed that the two highest days in sales amount (weekends) have the lowest staff in attendance.
- Advertising expense is significantly higher than the benchmark data for both current and previous year. Given that the total income is in line with benchmark data, this indicates that promotion is not effectively translating to additional income.
- Vehicle operating costs for both current and previous year are lower than benchmark. The vehicle is used to freight stock from CBD to the site and for deliveries. The freight expense is currently included in the cost of stock and further review indicated that the business had incurred freight and potting costs of $17,001 – 7 per cent of the total cost of goods for the current year.

Key recommendations

1. Develop position descriptions for all staff positions.
2. Restructure staffing levels and responsibilities.
3. Review salary expenses and bring in line with benchmark data.
4. Implement staff accountabilities through key performance indicators for each staff member to monitor productivity.
5. Monitor and manage staff roster.

Additional areas of review

- At the request of owner, the percentage of sales attributed to applied (non-plant) stock, for example fertiliser, was evaluated. This identified applied stock sold for the current year was $18,043 (4.11 per cent of total income). The industry standard is approximately 30 to 35 per cent of all sales. This is particularly important as applied stock can often carry higher gross margin.
- Debtor's sales on average for the current year were 58 per cent of total sales. This compares with the benchmark for non-metro towns of 25 per cent. Debtor's days of 21 days indicate that collections appeared to be in order.
- Creditor's days of 58 days indicate slow payment to suppliers, as average terms are 30 days. This could indicate issues with cashflow and highlights the need for a cashflow forecast to be developed and maintained. This view is supported by the total stock on hand as a percentage of current assets at 40 per cent for the current year. This could lead to cashflow issues where short term debts need to be paid.
- The leverage ratio at 70 per cent (current year) is high for this type of business. This ratio will be impacted by the fact that the business is eroding equity through continual recorded losses.
- The return on assets and equity are impacted by the continual recorded losses.
- Internal controls were reviewed, in particular the cash handling processes. This review highlighted that a policy of one person to cover cash register activity each day has been implemented. However, a review of the customer transaction reports indicated that this policy is often breached, particularly on weekends when only two members of staff are working.
- Cash register sales are tallied at the end of the day to a tally sheet which details cash, credit, ETPOS and sales to accounts. The tally sheet is prepared by the person responsible for the daily register duties. There is no policy in place for second review, although if the sheet does not balance, a second person will review. This particular practice creates a high risk, as the person responsible for collection of cash from sale is also responsible for end of day cash reconciliation. It is possible that sales may not be entered through the register, or voided or entered as returned and the cash not entered in the register. In the event that this particular process occurs, it would be very difficult to detect under current procedures.
- A review of the customer transaction report also indicated that on many occasions staff were processing sales to themselves. This should not occur, particularly without supervision. It is recommended that all staff sales are processed by the owner or senior manager on duty at all times.

Key recommendations

1. Train staff to “up-sell” applied stock to maximise sales returns.
2. Develop a cashflow forecast to assist in adhering to supplier payment terms.
3. Amend and document current cash register responsibilities.
4. Review all internal control processes, with particular emphasis on controls over stock to avoid shrinkage.
5. Train staff on the importance of adhering to internal control processes.

Further details on recommended implementation for business improvement for the Bundalong nursery will soon be available via a new guide on the CPA Australia website. The guide, regarding improving business performance, will appear on the Leadership and management knowledge portal when available.

Appendix B: Checklist of suggested information sources for business evaluation

Strategic	One and five-year strategic plans
	Succession plan
Financial information	Financial statements – profit and loss, balance sheet
	Current year budget
	Current year forecast – profit and loss and cashflow
	Point of sale information – sales by employees, goods returns, no sale items and other relevant information
	Stock management records
	Work-in-progress records and reports
Compliance reporting	Taxation returns, including both annual and goods and services tax statements if required
	Loan, lease and other financing agreements
	Accreditation reports
	Financial statements
	Industry-specific reports
Policies and procedures	All human resources policies, including job descriptions, organisation charts and staff rosters
	All financial policies, including pricing, discounting and buying
	Internal control procedures, such as segregation of duties
	Disaster and emergency planning policies, including data back-up
Physical assessment	Review controls in place, such as security cameras, security of stock, security of passwords and other access methods

Appendix C: Example of a template for business evaluation

Analysis of industry benchmark to current and previous year

	Industry benchmark	Current year	Variance of current year to benchmark	Variance of current to previous year	Previous year	Variance of previous year to benchmark
Total income						
Cost of goods sold						
Gross margin						
Selected overheads as a percentage of income						
Advertising and promotion						
Salaries including staff on costs						
Vehicle operating costs						
Rent						
Bank charges						
Insert other key overheads for business						
Total overheads						
Net profit margin						
Personnel numbers (FTE)						
Working owners						
Sales staff						
Any other staff						
Total personnel						
Other benchmark information						
Stock turn rate						
Trading hours per week						
Insert other key benchmark information						
Percentage of sales made to account customers						

Profitability measures		Current year	Previous year	Variance	**Comments** (include any reference to budget and strategic plan margins)
Gross profit margin	$\frac{\text{Gross profit}}{\text{Net sales}} \times 100$				
Mark-up	$\frac{\text{Gross profit}}{\text{Cost of goods sold}} \times 100$				
Earnings before interest and tax (EBIT) margin	$\frac{\text{Net profit before interest and tax}}{\text{Net sales}} \times 100$				
Net profit margin	$\frac{\text{Net profit}}{\text{Total income}} \times 100$				
Break even analysis	$\frac{\text{Fixed expenses}}{\text{1 less (cost of goods sold)}}$ /(net sales)				

Cashflow, liquidity and solvency measures		Current year	Previous year	Variance	**Comments** (include any reference to budget and strategic plan margins)
Working capital to total sales	$\frac{\text{Total current assets less total current liabilities}}{\text{Total sales}}$				
Current ratio	$\frac{\text{Total current assets}}{\text{Total current liabilities}}$				
Quick (acid) ratio	$\frac{\text{Total current assets less stock on hand}}{\text{Total current liabilities less bank overdraft}}$				
Leverage (gearing) ratio	$\frac{\text{Total liabilities}}{\text{Total equity}} \times 100$				
Debt to asset ratio	$\frac{\text{Total liabilities}}{\text{Total assets}} \times 100$				

Cashflow forecast	Opening bank balances plus all receipts for the period less all payments for the period. The period can be as short as weekly, however, more commonly a cashflow forecast period is for a month. For businesses experiencing cash flow difficulty, it is recommended that forecasting is done more regularly than what is usual for the business.	**Comments**

Evaluation of funding sources	Review all loan documentation and finance facilities (such as overdrafts), including leases, hire purchase and debtor finance and ensure that each finance facility is readily available when required. Areas of review should include loan terms and conditions and financial covenants and reporting compliance requirements.	Comments

Efficiency measures		Current year	Previous year	Variance	Comments (include any reference to budget and strategic plan margins)
Stock turnover	$\frac{\text{Cost of goods sold}}{\text{Average stock held for the period}}$				
Total stock on hand to total assets	$\frac{\text{Total stock on hand}}{\text{Total assets}} \times 100$				
Debtor's days	$\frac{\text{Total debtors} \times \text{number of days in the analysis period}}{\text{Total credit sales for the analysis period}}$				
Creditor's days	$\frac{\text{Total creditors} \times \text{number of days in the analysis period}}{\text{Total cost of goods sold for the period}}$				
Total asset turnover	$\frac{\text{Net sales}}{\text{Total assets}}$				
Return on assets (ROA)	$\frac{\text{Net profit before tax}}{\text{Total assets}} \times 100$				
Return on equity/ investment (ROI)	$\frac{\text{Net profit before tax}}{\text{Total equity}} \times 100$				
Total sales to number of sales employees	$\frac{\text{Total sales}}{\text{Number of sales employees}}$				

Employee sales	Total value of sales made by each employee for the analysis period	Current year	Previous year	Variance	Comments
Employee 1					
Employee 2					
Employee 3					

Aged debtor's report Attach financial system report to provide detail on each customer	The terms below should match terms provided to customers	Current year	Previous year	Variance	Comments
Current					
31-60 days					
61-90 days					
> 90 days					
> 180 days					

Aged creditor's report Attach financial system report to provide detail on each supplier	The terms below should match terms provided by suppliers	Current year	Previous year	Variance	Comments
Current					
31-60 days					
61-90 days					
> 90 days					
> 180 days					

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