Business Paper

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Most people in business recognise that the purpose of being in business is to make money. In order that we are able to achieve this, we must simultaneously increase net profit, return on investment and cashflow. Do you currently have reports prepared (at a minimum) on a monthly basis advising you of these measures of performance. If not, you should have. If you are wanting to grow your business and you are not monitoring these financial indicators, your business will ultimately fail.

Reviewing the results of a survey conducted by A J Williams, "A Longitudinal Analysis of the Characteristics and the performance of small business in Australia", the correlation between the frequency of reporting and the survival of business was alarming. The results were as follows:

Frequency	***Survival Rate (%)***
At least monthly	*79.7*
Quarterly	*71.5*
Half-Yearly	*49.9*
Annually	*36*

Despite the fact that the survey was carried out in Australia, I believe that it drives home the point I am making – you require monthly reports at a minimum.

You cannot grow your business faster than your cashflow will allow – many do not understand the concepts involved here. Good management is concerned with walking the tightrope between profitability on the one hand and cashflow on the other. In addition, as the manager of your business your role is to balance risk and return. It is therefore imperative that you have a very solid understanding of basic financial management principles.

The area of Cost Behaviour and Activity-Based Costs are another example of financial drivers that need to be understood in a business. The costs incurred in operating a business determine

in part the profit that it is capable of earning. But we need to go further than that, as often business managers believe that one way to increase profit is to reduce costs. As a general rule, this is totally wrong. Firstly we need to understand why the cost has arisen in the first place – does it help to increase sales, does it help to increase return on investment or does it help to increase cash flow? If the answer to any of these questions is “Yes”, then any action taken to reduce these costs will be detrimental to the business. If the answer is “No”, then the activity or facility that gives rise to the cost should be eliminated, or an alternative that lowers the cost should be investigated. Every cost incurred by the business needs to be evaluated in terms of whether the cost provides for the objective of making money in the business. To do this you need to understand what activities drive costs and how your costs behave in relation to differing levels of those activities. To understand how to make a business perform better, you have to understand the activities that are performed and the way in which they impact on costs and therefore results.

The fundamental rule:

> If you want to manage a business, you must manage the activities that make up the business, and in order to manage these activities, you must first be able to measure them, because what gets measured, gets managed.

Gross Margin Analysis:

Many managers understand what the gross margin of their business is in an overall sense, but do you know that information for each of the products or services that you provide, and do you understand which of your customers are the most profitable to deal with. Whilst one product may provide an excellent gross margin, you may not sell many units of this product and the stock turnover may be slow, therefore meaning that the maximization of profit, return on investment and cashflow has not been simultaneously achieved. Obviously a better result may be achieved if less stock of that product is able to be held through investigating various other choices that may be available to the business.

This type of analysis also needs to be applied to your customers. In the same way that some products are more profitable for your business, so too are some customers. A customer who pays his account promptly or who recommends you to others, or who purchases from you more frequently, or who buys more each time he deals with you, is obviously going to be a more valuable customer than one who does not do these things. Rarely do businesses systematically identify who their most valuable customers are and even more rarely do they maintain close contact with their customers to determine how well or badly they are performing.

Break-even Point:

Do you know what monetary level of sales you need to achieve in your business to ensure that you break even? This can be one of the most powerful financial management tools but it can also be the most dangerous if it is not adequately understood.

You must have a stable gross margin and your overheads must truly be fixed in relation to the level of sales being calculated. Many costs only remain constant to a certain level of sales being achieved, and then jump to a different level to allow for an increase in sales capacity. This therefore provides for a completely different level of sales in order for the business to break-even. A thorough understanding of the behaviour of costs and related capacity of these costs is imperative to calculating what the business needs to achieve. In addition, the break-even sales required to cover the required level of profit you require from the business can also be calculated once this understanding is achieved. This can be a very useful management tool.

Many managers believe that the information provided in monthly financial reports will provide them with all they require to effectively manage the business. The performance of the business depends on the quality of decisions that are made. These depend on the quality of information made available to the people who make the decisions. Financial reports provide an excellent monitoring system for how well a business is performing in an overall sense. However, it focuses on the outcome, rather than the processes and therefore does not provide information in sufficient enough detail to monitor the performance of the activities. The key activities of the business are the activities that need to be monitored. A good starting point can be identifying the key components that make up total revenue and by monitoring those you can gather invaluable insight into how you can improve the business. These are regarded as the critical success factors of the business (CSF’s), and measurement of the components making up these factors are done through identifying which are key and monitoring those components. These are known as Key Performance Indicators (or KPI’s).

Control of Working Capital:

Ultimately we need for the business to generate more cash than it consumes. It is therefore necessary that tight financial control is exerted over the items that either provide cash or consume cash. These are very different items to those making up the profit of the business. Key ratios that should be monitored are the number of days in which accounts receivable (debtors) are turned over, number of days inventory is turned into cash or receivables, days taken to pay accounts payable (creditors) and liquidity ratios.

It is necessary that you have not only working capital management in place but also that your business strategy fits with the management controls in place. This way you will ensure that either the business will finance its own growth or have strategies in place for funding that growth through outside sources, e.g., bank funding, outside shareholding, owner's equity and so on. A small change to your working capital management can sometimes eliminate the need for external financing – small changes can provide huge results in this area.

If you do not have the knowledge in these areas to successfully manage your business, you need to take some immediate steps to obtain the training/coaching that you require. Refer to our list of services offered, in particular the Advanced Financial Management Programme.