LOCKHART business advisors

CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

… Advising for Your Prosperity…

Growing to Death

Most people are not surprised when a start-up business fails. But it's not just start ups that grow to death; it's also a common cause of business failure for mature businesses.

Start-up businesses often fail because they are undercapitalised. They grow until the money runs out and then they can't afford to fund further growth. The banks refuse to lend to them as they have no history and no assets to leverage, and then they die. It's an easy trap to fall into. The entrepreneurial spirit that drives people to start up a business is often the same spirit that keeps them focussed on a growth path. The mentality is that the faster you drive sales and bring in the cash, the more successful the business (and the entrepreneur) will be. However, this cycle of sales and profit is missing two key components; financial, and cash flow management. A successful and sustaining business has all of these elements.

For the more mature business, growing to death is often the result of unplanned growth opportunities. It's ironic that seizing a major sales contract or a big new client can be your business's ruin but it's more common than you think. More often than not it's an issue that business operators don't identify until it is too late.

Many business operators are very good at what they do. Most have an excellent knowledge of the business they conduct and understand their products and services. Most also have an in-depth knowledge of sales performance and revenue. Few however have a high level of financial management expertise, so when a big new opportunity presents, critical financial questions are not asked. As a result, there can be a sudden and unintended impact on their financial position. A rush of sales might be a great thing but it is not always counterbalanced by a rush of income and profit. Free cash and liquidity are the victims.

Big one-off opportunities can also be dangerous because they are rare. For businesses without strong financial management and control, there is simply no way of understanding what impact the opportunity will have until they have experienced it. With no background history to rely on, the warning signs of impending financial crisis don't appear.

Sudden growth comes at a cost. That cost can be at a profit or at a cash flow level. Profit and cash flow are not the same and where operators don't have a lot of financial expertise they generally rely on profit analysis without considering the cash flow implications. You need to understand the cash cycle and its timing within your business.

The first step is to understand that sudden change creates a different dynamic and brings cost and cash flow implications with it. It's essential not to embark on sudden change without identifying what these implications are.

Let's look at an example:

Jonathon runs a typical small business. Since taking over the established business a year ago growth has accelerated. The primary product of the business is brought in from overseas. The business is predicated on a budgeted turnover of $70,000 - $100,000 per month. The working capital in place accommodates the business operating at this level which is already a step up from where it was when he bought it.

Jonathon knows the business has a lot of potential and he's been working hard to fulfil its promise. He's ecstatic because he's brought in five major sales all within the $50,000 - $200,000 range and all expect delivery within the coming 3 months. While the big sales required a dip in the gross profit margin, it's still doable.

If all of the orders come through, the impact of the new sales will take his turnover from its current level of $100,000 per month to an average of $250,000 per month for the next 3 or 4 months. If you imagine yourself in Jonathon's place, it would be hard not to be impressed with your efforts wouldn't it? What a boost to the company.

Now add in another factor. The primary product is purchased from the supplier without trading terms so the outlay for any major sale is in advance. As a result, the cash flow implications of the time between each sale, the purchase of the product from the supplier, fulfilment and payment by the customer is critical to understand. For Jonathon, the highest risk is the major outlay of cash required to fulfil the sale. He cannot buy time.

When Jonathon had a cash flow analysis put in place to determine the impact of the new sales it revealed that he needed $200,000 to $300,000 more cash than he had. He knew it might be tight but didn't realise the situation was that stark. As a result of the analysis, Jonathon was able to work with the customers to stage the orders and manage the cash flow requirements.

Had he fulfilled the sales without the analysis, he would have had a funding gap of approximately 60 days where he was exposed by $250,000 without the capital base to support him.

While the details might be different, situations like Jonathon's are not uncommon. The problem is that unless you have strong security, the chance of any bank giving you an increase in funding is unlikely. Banks want to lend to businesses that have good financial management. If you approach them once a problem such as Jonathon's has occurred, you have already proven the case in the negative and set yourself up for rejection.

In the example above, cash flow was the major issue. In others it is profit. Large customers with large orders may expect you to cut your margin.

Or, they might ask you to discount if they 'up the order'. The danger is that you, or your sales people, get carried away with the headline number and don't look at the profit contribution. Some sales, even big sales are simply not worth it as you can't trade below a certain profit level. For businesses with higher fixed costs your ability to negotiate your margin is less flexible than those with higher variable costs. The key is to know your break-even point before entering into any deals.

And, discounting can be its own trap. For example, if your margin is 40 per cent and you reduce your price by 10 per cent, you need a 33 per cent increase in sales volume to maintain your profit level!

Audit Shield Summary

accountancy insurance

Better safe than sorry . . . Are you prepared?

It is no secret that the Australian Government and the Australian Taxation Office (ATO) will go to any lengths to raise revenue. One way of reaching this goal is by pursuing audit, enquiry, investigation or review activities in regards to lodgements for businesses, taxpayers and Self-Managed Super Funds. As well as the additional funding the ATO has received, further data-matching capabilities allow for a more accessible landscape for them to come knocking on an accounting firm's door.

If you are subjected to an audit, enquiry, investigation or review you are responsible for the professional fees that may involve **Lockhart Business Advisors** providing the required information. Even the simplest enquiry can require hours of work. In some cases, when there are complex environments, unusual circumstances, multiple years or multiple companies and trusts, thousands of dollars in accounting and legal fees can be incurred. In many cases, those who are audited are compliant and have done nothing wrong. However, work must still be undertaken and thus professional fees will be incurred.

Lba has responded to this growing threat by sourcing the most comprehensive tax audit insurance available and are pleased to offer to you and your business our Audit Shield Service. The Audit Shield Service is fully tax deductable providing you with peace of mind in relation to audit, enquiry, investigation and review associated costs. The features of this are:

- **Lba's** accounting fees in responding to audits, enquiries, investigations and reviews of your lodged returns, including those from previous years are covered.

- Specialist's professional fees if we need to engage a tax expert or lawyer for an opinion or defence are covered.

You may have received a letter from us explaining the policy and inviting you to offer we participate under our Audit Shield Service. Should you have any queries in relation to the encourage you to contact our office.

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