BookkeepersHub
Connecting Australia's bookkeepers with business

MORE PROFIT, LESS STRESS

INSPIRING GOOD BUSINESS

More Profit

Less Stress

Understanding the profit drivers and financial performance of a business

Author, Publisher: Australian Bookkeepers Hub Pty Ltd

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Less Stress

FOREWORD

At *Bookkeepers Hub* we believe that our business is to help improve our member's business skills to better service their business customers and to grow their bookkeeping business revenues that's why we developed content and resources to facilitate this mantra. More Profit, Less Stress is an important foundation of this work.

A book takes time produce – management time, editors and designer's time; importantly it involves skilful interviewing of business exerts and this can only be achieved at optimal level using qualified business journalists and writers. We made this investment to help you identify and realise the full profit potential of your business. What we set out to achieve is to inform, educate and resource you the bookkeeper or student to be able to interpret business data and deliver manful and value-added services to help the business owner thrive.

We will do this by showing you how to focus on the key revenue and cost drivers of your business using information technology and simple strategies that even a mathematically-challenged business owner can operate. We understand two things:

1. That intermediaries – both accountants and bookkeepers need to have a better understanding of the drivers of business and not just the 'language' of business, that is, which sits in the accounts of the business
2. We understand that people don't go into business because they enjoy financial accounts: they go into business because they are good at what they do.

The fact is that many businesses don't get a suitable rerun form their investment – their money, their time - because the business owner often abdicates responsibility for the financial management. Often it is left unattended or left to the accountant. The great majority of accountants however are concerned with helping the business owner with tax returns, BAS statements and statutory returns. He or she may even help you structure trusts and companies but they aren't operations managers.

Consider for example, the very contemporary issue of pricing your products or services. Can you accountant really be strategic advisor here when you are the one that knows your market? You might be tempted to discount in which case you might run to your accountant to help you crunch some numbers; but that's expensive and it may be better for you to have some tools on hand to do 'what if' scenarios.

Business models are hard to change – and the tendency is to cut prices and cut costs to meet the 'new rule'. Which raises another challenge: how do you avoid going under water by taking these actions? A real problem when many business owners today don't really know how their business is travelling day-to-day.

US author Michael Gerber of E-Myth fame talks about the "Entrepreneurial Seizure", where you as a business owner fall victim to the "most disastrous assumption anyone can make" about going into business. It is an assumption made by all people who have some skills and who go into business for themselves to leverage those skills. That "Fatal Assumption" (Gerber's words) is: "if you understand the technical work of a business, you understand a business that does that technical work. And the reason it's fatal is that it just isn't true."

In fact, it's the root cause of most small business failures. Most people are not all that literate in financial management. Know the difference between cash and profit? Direct and fixed costs? Surprisingly, many business owners say no to these questions.

Without financial management, the business owner is driving a car without a dashboard.

Business owners can be blind-sided by financial statements and reports. They get the statements from their accountant and focus only on what they need to pay the tax office. Few will actually do any financial analysis. And few bookkeepers or accountants offer this as a stand-alone service (or as a bundled service: see www.bookkeepershub.comau/fee-for-service/pdf.

If the financial management of a business is left unattended then the effects and consequences can be disastrous. Customers are taking longer to pay, thus constraining cash flow. The sale is not made until the money is in the bank. Poor credit control or debtor management can lead to business failure; at a minimum is can create stressful conditions for the business owner – and their staff and advisors

Getting the SMB to do any real financial analysis such as a debtor analysis, forecasting cash flow, and accounts receivable is crucial. Setting prices in a competitive framework requires analysis. Matching prices to competitors may be necessary but discounting can be dangerous to the financial health of a SMB.

Some business owners discount without fully appreciating the impact on profits. You need to have a significant increase in volume. For the average business a 10 percent discount would require something like a 30 percent increase in volume to maintain profit levels.

Pricing is very much a strategic financial issue. You have a business to run and it needs to make a profit. Exactly how much profit you want to make, and by when, should show up in your overall strategic objectives.

The message: make the numbers an imperative. Put them front and centre in a way that the business owner really has at her fingertips a snapshot of how the business is travelling. If you have a system that can produce timely and accurate financial statements, then use them. Today even the most basic cloud-based accounting software systems can produce customised 'dashboards' for decision-makers.

Key reports such as the balance sheet can give a picture of how well the business is performing; and there income statements informs on the cost of doing business, your gross margin and profits; and, finally cash flow statements which gives you a forecast of where cash crunch times are likely.

Financial management is about looking at the history of actual sales, so that an estimate of returns can be made for the various products and services. It's about determining how much profit the business will make by selling Y amount of product at X amount of dollars over the same amount of time.

Discounting may be one way to meet the competition but if you can't increase volumes the business owner might consider trimming some fat away, either though hitting fixed costs, inventory or less profitable lines. With financial analysis the decision-maker may discover that there are some products or services that are costing more to provide than can ever be recouped.

Today business needs to invoice quickly and have an efficient collection method. You need to follow up. This is just one of the steps you can take to unleash your business's potential. We believe that the bookkeeper accountant can be more informed by studying the financial drivers of business.

This book is written with the financial advisor in mind; to enable her to build her financial intelligence and to use that in delivering higher-value services to the business client. It is thus written in a style that addresses both the learner's perspective and to put them in the perspective of the business owner, hence content will 'speak' from time to time to the business owner/entrepreneur.

Contents

Know the Numbers

Increasingly, business is a numbers game. It is in business finances that numbers really count. Capital; whether it be start-up capital, working capital, or expansion capital needs more than an application; it needs a quantitative masterpiece these days!

If the idea of developing credible financial projections makes you wince, or if you think it's a meaningless exercise as an intermediary whether bookkeeper or accountant, then think again about the role of an intermediary in a digital environment where accounting software suppliers as well as financial from such as the Big 4 accounting firms, are selling accounting system as complete DIY solutions. Of course the idea that a system can spit out meaningful information that is customised for a particular business is unrealistic especially since there is such a yawning gap in the mindset of business owners who would rather focus on top line performance rather than financial analysis

In short, if you as an intermediary are going to put on an advisor's hat, even the most basic of your projections demonstrate that you understand the economics of the business.

Venture capitalist and occasional presenter at the Stanford University Centre for Entrepreneurial Studies, Guy Kawasaki, concurs. He writes "They (projections) should tell your story in numbers—what drives your growth, what drives your profit, and how your company will evolve over the next several years."

When you consider the mindset of investors and bankers, it should come as no surprise that in a credit cautions world, money is going to be harder to come by. Good ideas are fine as are historic sales in the case of an established business, but future-proofing your funding application is mandatory.

When applying for finance, probably the most important factor influencing investors (and bankers) is validation. Do you have a consistent business where revenue triggers and collections are predicable? The more credibility and customer traction you have, the more likely investors and bankers are going to be interested.

As Kawasaki writes; "You may think you are doing well, but a little outside perspective and quantitative data may tell you otherwise." To secure funding today, you need an excellent grade across all your submissions to financiers. It's a tough environment out there, so don't waste your time with a piecemeal document that is not compelling and credible.

It may be motherhood stuff, but billing quickly, efficiently and collecting on debtor invoices remains one of the more effective means of managing a business's working capital. Any professional would hardly be surprised at how few businesses have efficient processes and systems in place. To get an industrialised system may require rebuilding.

One rea of concern is the current economic setting is the increasingly conservative protocols being imposed by the banks of business lending. In short, it's tougher to get a loan for working capital requirements without bricks and mortar security. It is critical today to have documentation and reporting systems in place that can provide the business owners, lenders and investors with a sense that you understand the economics of your business.

Applications for loans for business invariably go to a credit department in the bank. Projections of cash flow and P&L are very important but credit people are often influenced by an independent analysis of free cash flow (as part of a capitalisation of profits analysis).They might say "these people are on top of their numbers.

Increasingly service providers are integrating with accounting software platforms to provide tools for managing debts and for testing the credit worthiness of new business customers if they are needed credit. Develop good relationships with the people you pay and the people who owe you money. The phone call that asks a supplier for a few more days to pay a bill or the phone call that calls in funds that are overdue, can be important levers in cash flow. Relationships are vital, but so too are credit reports (such as those provided by Creditor Watch (www.credtorwatch.com.au and automated reminders for late pays such as these provided by DeebotDaddy (www.debtordaddy.com.au)

Business owners need to be particularly vigilant about late payers. Offer discounts for early payments if necessary and jump on overdue debts immediately. The phone is your friend in this situation. Rushed decisions based on poor information are particularly dangerous at these times. Keep your numbers current. For the bookkeepers, the imperative (and business opportunity) is to present systems and solutions to execute on this.

Know the target market

You may have a good idea, but is it a good business proposition? Not all good ideas make money. Some number crunching to test your business case is essential whether you are just starting or planning to expand.

Starting a business is easy – perhaps too easy. Once it required foresight, a business plan and capital scraped together from savings, friends and family. Today, an entrepreneur can sketch an idea on the back of a napkin in the morning, register an internet domain company, pull down a template, have a website hosted and running by the afternoon.

Even the mobile phone companies will offer same day service for a start up. However, the ability to quickly seize upon new market opportunities can be a double-edged sword, as many of our entrepreneurs will tell us: some are faced with almost unsurmountable hurdles to build a defendable and survivable business. We all know its takes determination and a tolerance for risk in large dollops to start a business but it also takes simplicity too.

Changing direction and market niche is not uncommon in the early stages but is risky. Boutique hotel entrepreneur Paul Fischmann says his first venture – several backpacker lodges in inner Sydney - failed because he was inexperienced. “I was 22 and too cocky. I thought I was invincible and took my eye off the ball. I diversified into restaurants, wine bars.” The experience was formative giving Fischmann ample experience in identifying gaps in the market as well as knowing what had to be done next. He says he was determined to come back with a better business model within six months. “I focussed on building a diversified portfolio for my venture – Eight Hotels – and a robust business model that is sustainable. Even with failure you are building capability.”

Fischmann attributes some of his current success to the internet’s power to level the playing field, echoed by online business owner Julie Sweet. Founded in 2005, her business www.certificatesonline.com.au provides a service for people who are time poor. Ms Sweet describes her business as “An effective and highly efficient service which obtains full, original birth, marriage, family death certificates and changes of name for eligible applicants Australia wide, without the person/s going anywhere. We do it all for them within 24 hours.”

Ms Sweet says “I wasn’t fulfilled working for big companies and I wasn’t going to achieve financial freedom. Perhaps I was naïve but I saw my own business giving me freedom, independence. I identified an opportunity to offer an online service but I didn’t realise the huge commitment. It’s a vastly different environment starting your own business. Of course if it wasn’t for the Internet I probably wouldn’t be in business. Despite the hurdles, failure was never an option.”

The internet with its extremely low barriers to entry has levelled the level playing field for entrants to small business. The internet is great enabler but a start up entrepreneur with a great idea needs more. In business, to produce

something worthwhile you have to take risks. Small business owners intuitively understand risk in the purest sense of the word. You can lose your capital. They are exposed to that risk. Finance comes in the form of equity or debt. But debt is going to be a mortgage over the house. This may be no bad thing. Skin in the game is important. It focuses the mind amazingly.

For Gabby Leibovich, there was no doubt in his mind about his future. As retailers working in the consumer electronics market he and his brother Hezi identified an opportunity to build an online store offering discounted goods. The business, catchoftheday.com.au offers just one product on its website each day until it is sold out. “It’s built on the premise that suppliers want to get rid of end of line stock. We offer to take the stock at a reduced price and sell it online.”

With a database now numbering in excess of 400,000 and revenues approaching $40 million, it is proving to be a winning formula. However, despite being profitable from day one, the business was not without its risks. “We risked all our capital in setting this up and we didn’t know if it was going to work. In 2006 we planned on selling 60 items a day; now it’s near 4,000. I dare say we were fast learners.”

And perhaps telling us that risk taking is overrated: that successful entrepreneurs learn how to be competent in business and do the research about their market.

Is there a market?

Do a market analysis to find out as much as you can about the marketplace, your customers and your competitors. You want to be sure you are giving your customers exactly what they want, when they want it, packaged and delivered in the way they want, and at a price they can afford and are prepared to pay.

Your customers

If you haven’t done so already, develop a list of target prospects. Decide who they are (age, location, income group, occupation, hobbies) and find out as much as you can about them. Your aim is to concentrate your marketing strategies on these customers who are most likely to buy your product or service. To find out what your customers think of your product and what price they are likely to pay, speak to them directly through a focus group or an online survey (like Survey Monkey) or questionnaire, talk to passers-by in a location that your target client frequents, or arrange a product trial or test. A market research company can help you with this.

Your competition

Do a SWOT analysis on who you will be competing against, how long have they been around, what they sell, how much they sell it for and why people buy from them. How will you compete? Remember, your competition isn’t only other businesses that sell the same things as you. It can also be ones that are competing for the same customer dollar. For example, if you sell chocolates, your competition can be someone nearby who sells flowers.

Doing the Research

Look for your competitors in the Yellow Pages and trade directories, or through the internet. Phone the Australian Bureau of Statistics or visit their website www.abs.gov.au to access information about businesses similar to yours such as total income, operating profit before tax, wages and salaries. Industry associations will provide information about your sector.

Know the cash needs

An accounting profit is one guide to the health of a business but its cash flow tells the real story. It could be making a profit on paper and still be going broke. If what is being paid out exceeds what's coming in, a business can be in trouble, even if, in accounting terms its transactions are profitable.

Poor cash flow is one of the main reasons that small businesses fail. The important thing to understand is that many profitable businesses can go broke because they didn't have enough cash flow to support their business in the short term.

A month-by-month cash flow budget (see below) will help you forecast whether you have sufficient cash in the bank to pay the bills each month – and help you sleep better at night. A cash flow budget simply records the amount of money that you expect to flow in and out of your business over a given time frame – usually 12 months.

This cash flow budget should be based on a series of assumptions about how your business has performed in the past and what you expect to change in the future. If you are starting a business from scratch and do not have previous records then it is even more important to back up your cash flow assumptions with market requirements, planned fixed expenses and information on similar types of businesses.

Once you have completed a cash flow budget make sure you use it as a living document. Track your projections against actual receipts and expenses when they are made. This will help keep your finger on the pulse, manage expenses and income and plan for any unexpected issues in advance.

It's also important to understand where cash can get tied up in your business – primarily stock and debtors.

Cash flow is so crucial that it is worth running through a typical start-up business situation as an illustration.

> *You have opened an air conditioning installation and servicing business, Keep Kool Pty Ltd (fictitious name) on the Gold Coast of Queensland, with $50,000 of savings and funds raised from credit card advances. Your first order comes in quickly and is actually a maintenance contract, followed by a series of medium-sized installation deals. You're off to a great start. You have orders on hand for four months of work; $71,000 worth and you have calculated that you will generate a profit of $8,700 on this revenue. You'll be profitable within four months – remarkable for a as start-up business!*
>
> *You hire several people, one to handle the service centre and two technicians to assist in the installation and maintenance work, while you do marketing and the managing of new accounts. Salaries for your first month end up costing $10,000. Rent is $2,000, and you pay $3,000 to suppliers for furniture, new stationery and business cards, and other operating expenses. By the end of the month, the cash balance is down to $35,000.*

But you still haven't sent out any bills because you want to use an integrated billing and accounting software package that you haven't fully worked out.

Month two *dawns, and you immediately siphon off $16,000 for salaries and various operating expenses, such as legal fees to do with the lease, equipment rental, travel and insurance. Then an unexpected extra cost: legal, insurance and bank fees to help you get your payment and banking system up and running. The cost: $3,000.*

You send out your first batch of invoices, but you allow 60 days for payment. After all, you don't want to appear too demanding. After you pay the rent, the bank account is down to a cash balance of $16,000, and has yet to receive any revenue.

Month three. *You have no time to solicit new business because you're been out for a whole week helping with the work as one job requires a good deal of fiddly work needing two people in attendance. Another $13,000 goes out of the bank account, and although an invoice for$8,000 is paid the cash balance is now just $3,000. But you know some more cash is coming in very soon.*

Month four*. A couple of payments come in but you need to settle on some stock and you finally are ready to get your catalogues printed, along with all the ancillary printing requirements for single-sheet glossy fliers and business cards and the like. The problem is the local printer won't give you credit because you're a new customer. Printing the materials in another city isn't cost-effective, so you fork out the $12,000 for the job, including the graphic designer's fees. Once the rent cheque goes out, there's not enough in the kitty. Next month's commitments cannot be met without outstanding invoices being settled and it's not yet 60 days since they were sent out, so there is no leverage available. There are no funds available for marketing – publicity and promotional activity. The business is already in a cash crisis, yet sales are being achieved.*

The moral of this real-world story? Don't fund your customers' expenses. Send them their bills on time. Don't let them pay late. Make sure to bill for all of the work that you do. And, above all, never lose track of cash flow.

These are basic lessons of cash management, but that's exactly the point.

Small businesses wind up taking big orders that get them in trouble. They want the big contract, but they're not getting enough money at the front end of it and they don't have the cash reserves to pay workers and other bills while they're waiting to get paid themselves. They might show a profit on an accrual basis, but from a cash-flow standpoint, they don't.

So what are the key, measurable (and manageable factors that business owners need to focus on in order to maximise profitability.

1. Get pricing right

As we noted at the outset of the book, determining the price to charge for a product is frustrating for most businesses, especially in the digital age where consumers are looking for deals online. The internet and peripherals – Smartphone's, iPads and the like mean that decisions taken by consumers can be potentially devastating to a business that is not – literally – switched on – to competitive pricing.

Getting your pricing strategy right is critical to your success in business because it affects many areas of your business. The pricing strategy impacts the type of customers attracted to your business, the quantity of product sold, how the product is perceived, product promotion and your profit.

There is no single way of determining the best pricing strategy for your business. The following is a list of factors that you may consider when developing your pricing strategy:

- The type of customers you are targeting (see earlier notes).
- The positioning of your products in the market.
- The relationship between the price and quantity sold.
- How you will promote your products.
- How you will distribute your products.
- The costs associated with your products including the fixed and variable costs.
- Your competitors and their pricing decisions.
- The objective of your pricing strategy.

2. Reduce cost of goods sold

This tactic relates to the question of discounting that we raised earlier in the book. It complements the first discussion on 'get your pricing right'.

The gross profit margin is the difference between the price you sell your product for and the price you paid for it. Increasing the margin between the two will increase your profit and your cash flow. There are two ways to increase your gross profit margin:

- increase your price (as discussed above)
- and/or decrease the cost of goods sold.

The cost of goods sold is the cost of the product to you that was sold to your customers.

Examples of ways to reduce your costs of goods sold:

- Negotiate with your suppliers for a better price if you buy in bulk. Only use this strategy if you can turn over the stock quickly.
- Negotiate with your suppliers for a discount if you pay early if there isn't a discount already in place.
- Shop around with other suppliers to ensure you are getting the best value (this is not necessarily the best price).
- Purchase new equipment or implement new processes to produce the goods more efficiently.

3. Prepare cash-flow forecasts

A cash-flow statement is probably the most important thing in telling you if your business is on or off target. Cash-flow statements keep track of the cash that comes in and the cash that goes out of your business, as well as where the money ends up. These statements are crucial. Projected cash-flow statements ensure that you never find the cash drawer empty at the end of the month when you have a fist full of bills left to pay.

Let's look at Keep Kool's books to see where their fatal flaw occurred:

Profit and loss statement

	January	February	March	April
Revenue	$17,000	$17,500	$17,800	$19,000
Direct costs	$12,900	$12,300	$11,900	$10,400
Gross profit	$4,100	$5,200	$5,900	$8,600
Gross profit margin %	24.1	29.7	33.1	45.2
Expenses	$2,200	$1,900	$2,400	$13,700
Profit before tax	$1,900	$3,300	$3,500	($5,100)

Cash-flow statement

	January	February	March	April
Funds in	0	0	$8,000	$11,000
Funds out	$15,000	$19,000	$13,000	$22,000
Change in cash position	($15,000)	($19,000)	($5,000)	($11,000)
Total cash on hand	$35,000	$16,000	$11,000	0

Note the disparity between a healthy, rising trend in operating margin and the net cash position. Don't assume that as long as you make a profit on your goods every month, you'll always have money in the bank. It just doesn't work that way in business. It's another illustration of the value of timely and relevant information.

Cash flow is all about timing. A business can be profitable and still have cash flow problems.

Prepare a three month cash flow budget. A cash flow budget includes all the expected cash inflows for the month less all the expected outflows for the month.

Know the expenses

It is a fundamental tenet of financial management to regularly review your expenses by comparing them against your budget and prior periods. If an expense is greater than budgeted or than the previous year then investigate the reason for the increase.

Examples of how to control your expenses:

- Compare expenses against your budget.

- Compare expenses against the previous year or period.

- Compare expenses as a percentage of sales.

You might also get hold of your industry benchmark (ask your association or one of the commercial service providers)

- Prepare regular financial reports.

- Rearrange annual payments into small payments. This generally costs more and should only be used when needed to avoid cash crunch periods. Revert back to annual payments once you are able.

Manage debtors

A sale isn't a sale until the money is in the bank. A well managed debtors system is critical for a successful business. Ensure your debtors system has preventative measures as well as a step by step plan to recover overdue accounts.

Some examples of how to improve the debtors system:

- Credit checks for all new customers.

- Request a deposit on signing/agreeing of contract.

- Discounts offered for early payment.

- Make it as easy to pay as possible. Offer to take credit card details.

- Send out invoices immediately.

- Regularly review aged receivable report and consistently follow a step by step plan to follow up overdue accounts.

Manage stock

Controlling how much stock is on hand can be both an art and a science. Not enough stock will lead to lost revenue. Too much stock can impact on cash flow. I have seen how both can have a major impact on profit and cash flow. More often than not, businesses have too much stock that is tying up valuable resources. However, they have not considered the hidden costs by holding onto old stock such as missed opportunities due to poor cash flow and shelf space that could be used by a fast moving product. With a good accounting program you will be able to make an educated guess about how much stock to carry.

Examples of how to improve stock control:

- Monitor stock regularly. Use ratios such as inventory turnover and days inventory to compare to previous periods and industry standards.

- Clear old and outdated stock by packaging together or discounting.

- For fast moving stock, buy in bulk to receive a discount.

- Focus on a 'just in time' ordering system to save build up of stock.

Don't pay too much or too early

Ensure you have a step by step purchasing procedure that is followed and monitored. Lack of proper procedures and monitoring may lead to purchasing too much, paying for undelivered goods or overpayments.

Examples of how to improve purchasing and creditor payments include:

- Pay your creditors on the day the invoice is due. Do not pay early or late.

- Negotiate longer payment terms or a payment plan if the business is struggling.

- Negotiate discount for early or up-front payment.

Reduce owner's salary or drawings

One common problem in small businesses, especially those with poor financial reporting, is the owners withdrawing more cash than the business is generating. The owners may be taking a wage that is in excess of the business's profit or may withdraw money out of the business bank account for personal expenses without consideration for future business cash outflows. This can destroy a business very quickly.

It's balancing act between reinvesting the profits to grow your business and enjoying the rewards of your hard work now. This balance will depend on your individual circumstances. A new business will need to reinvest more of its profits to grow compared to a mature business.

Know the ROI

What is important is your return on investment (ROI). After all, the only real reason you're setting up, running and managing a marketing or social media campaign is to make money, right? It's about return on effort.

The Lifetime Value principle

Here one of the principles that we assert here is that customers are not about the next sale from a customer; rather a customer has (or should have) a lifetime value. That's the amount of revenue you'll generate from one customer over the lifetime of your engagement with them minus your costs to acquire them and then service them over time.

Let's say you're a mobile phone service provider and you know that the average customer spends $100 a month on your service. Over the course of 12 months, you generate $1,200 from the typical customer. But that customer doesn't stay with you for just 12 months, they stay with you for 3.5 years. The revenue you generate from them over the time that they remain your customer is $4,200 ($100/month x 12 months x 3.5 years).

There is a cost you to service that customer each year for the time they remain your customer. Assume that each year, this amounts to $30 per month. The cost to service them over the span of time as your customer is $1,260. ($30/month x 12 months x 3.5 years).

In the most simple calculation, a customer lifetime value this would represent the revenue generated by that customer over the 3.5 years = $4,200 minus the cost to serve that customer over the 3.5 years = $2,940. If the cost of acquiring the customer is say 10% of customer lifetime value, you might spend close to $294 in marketing costs to gain a new customer. That's normally referred to in marketing texts as Cost per Acquisition or sometimes called Cost per Sale.

This is a good, basic formula for understanding the metrics of your marketing effort's ROI. Note however (as many business owners will already know) as a general rule of thumb for most businesses is that it costs 3 to 5 times as much to get a new customer as it does to keep an existing one. That's part of the reason most businesses focus so much time and money on customer retention – it pays to keep existing customers happy.

If there were competitors very active on social media for example, inviting members to come and see new product videos or come along to events, it would be smart to focus time and money on keeping the existing customer satisfied. At the very least a presence online would give you market intelligence on competitor activities.

Alternatively, many an executive of a large company has noticed that some customers of large telecoms or banks were venting their frustrations about these companies on Twitter. It could be a useful lesson for a telecom operator.

All that said, these metrics can give you an idea of how to create a model to calculate the ROI of one aspect of your marketing program.

Generating leads

In sales both online and offline, a lead is an inbound prospect who is interested in your product or service (or, as the case may be, in your competitor's product or service). If you can capture a lead and nurture it through the sales funnel, you'll be able to convert that prospect into a customer. And that means revenue for your business.

The challenge many people face when they use internet marketing or social media to generate leads is that they don't go last few yards. In other words, they use social media to build awareness and generate demand for their products or services, but they don't know how to take it the final step and turn it into a viable lead.

If you are an expert say in renewable technology (for example and energy cost consultant), one of the best ways to use social media to generate leads is to become a "thought leader" and information station for people in your field. The audience – other professionals or top-line executives in large corporations - will be very busy, but nevertheless interested in staying abreast of the latest ideas. He will be perhaps, downloading 2 to 3 white papers a month but only has time to read a couple of pages of those white papers. The rest get stacked up on their desk -- unread -- and then get tossed in the trash about once every 3 months.

But what if you could distil those white papers down to their essence? What if you could take the most important information and put it into a short, 60-second video that provided the key bits of information about the paper or technique or product to the executive or professional. This could be posted on YouTube and signalled in an email. A result is an engaged and loyal prospect base, some of whom convert to customers/clients.

A lead coming from social media or from a letter box drop still needs to be actively pursued and converted into a customer. This is where good, old-fashioned hard work comes into play. There's this thing called a telephone. That's the final yard. Executing that last yard is what differentiates the social media wannabes from the social media super stars.

Measurement

A marketing effort or campaign that isn't measured isn't effective because there's no way to tell if it worked. The specifics of measuring a social media campaign are going to vary with every business, but let's use a basic example to illustrate the approach. Let's say that you're an office cleaning company and your typical customer spends $250 per month on your service and stays with you for 3 years.

For the sake of keeping this illustration straightforward, let's also assume that you have no additional ongoing servicing costs while they are your customer. That gives a lifetime value of $9000 and a cost per acquisition of $900.

In the past, you might have used direct mail as your primary tool to generate leads and convert those leads into sales. If the conversion rate on your direct mail campaigns was 0.5%, you'd have to send out 200 direct mail pieces to acquire a customer.

If your printing, postage, list and marketing costs for those direct mail pieces was $2 each, then the math works out at $400. But lets' say you want to start a marketing campaign against the existing direct mail campaign. The costs associated with setting up, launching and running an internet marketing or social media campaign are often under-estimated. Since the paid media for internet marketing (email and not paid Adwords) is close to $0, people assume

that social media is inexpensive. In other words, since there are no media costs for using Twitter, YouTube, Facebook, LinkedIn.

The manpower involved in running a campaign can be significant. So can the costs for producing the content for your social media campaign. If you're a large company with a brand to protect, you'll want to create top-notch landing pages on your website. That costs money. So do well-produced YouTube videos and effective Facebook promotions.

For example a 2-minute clip to YouTube would cost anywhere from $500 to $5,000 to produce and package.

The point is that you'll need to take some risk into some of the hidden costs of internet marketing and social media. You can take a stab at some of the costs but you may need to do that other mantra of business: "things take twice as long as estimated and cost twice as much", in order to get a good, clear understanding of the ROI of your campaign.

In this illustration if your goal is to double the size of your business from say 100 customers to 200 over a 6 month period you have around $40,000 of budget to play with in order to justify a marketing campaign.

As we have already internet marketing or social media can only drive leads not sales. One of your objectives would be to drive, say, 5,000 people to your landing pages via your campaign. Assuming you were able to do that, it's reasonable to calculate that 100 of those would convert to customers, which would match your direct mail campaign dollar-for-dollar. From that point on, it's simply a matter of testing ways to grow your inbound traffic and testing ways to improve your conversion rate.

The most important outcome from all of this is not to establish an exact ROI but a more realistic return on effort. It's about being able to track what impact you can make via the marketing channel and whether this can be a sustainable element to your business. One way is to measure the costs per conversion as above but it's also about seeing the return on effort over the long term, say over two or three six-month periods and watch how you can impact lead generation and conversion with innovative marketing. Assuming the ROI or ROE is positive, you'll be able to grow your campaign and improve efficiencies over time.

Know the growth model

Money isn't the only thing the tiny business will need before it can become the next mega business. There are steps along the way which require some adept management both at a financial level but also at a strategic level. Think of a business as needing to consolidate before it can reach each new stage of growth.

In the first stage, where a business has sales of less than $1 million and is proving its concept. The next stage is a time of scaling up operations, where financial management and good reporting systems are vital; and the last is achieving a professionally managed business.

Most entrepreneurs are good at thinking about the product and the market, but, apart from financial management which we have examined earlier, they are not good at the other part of the business that will make them successful, which is the infrastructure - operational and management systems for example. What works now when they are small is not going to work when they are much larger. The infrastructure includes a company's resource management, operational and management systems.

To successfully navigate the second stage of growth -- the scale-up period between $1 million and $10 million in annual sales -- the business may have to build a core group of senior management; maybe team of three people that we call the leadership team, that functions as a real team to scale up rapidly. The team performs four basic functions: setting the vision, creating the culture and setting up the systems and the operations.

Geographic expansion: a tutorial

Most entrepreneurs who are on the right part of the growth curve are forced to reach out to new geographic markets. To do it right, a number of issues need to be examined:

1. Make sure it's what you want. You may get more revenue but you may also greatly increase the hours you need to work--especially if you'll have to travel. New markets need to be visited and tested. You may also reduce how much control you have over the business, as you must delegate authority to others.

2. Pick the right time. One indicator is when you've maxed out the potential of your current geographic markets but you haven't overloaded your capacity. Geographic expansion is for when you can handle more and you know there's a bigger world out there.

3. Have the people in place. Adding new geographic markets usually means adding people, including management positions. Before expanding, identify suitable new hires or existing employees who have the potential to move up. Can head office handle all admin for example or is there a need for direct, on-the-ground customer service support?

4. Manage costs carefully (and measure them constantly using our work earlier in the book). Expanding can add costs even faster than it adds sales. Add 50 percent to any estimate of the cost of opening in a new market as a buffer.

Overruns can come from unexpected places. For example you may need special security needs or specialised storage requirements that add costs. Legal costs associated with leases and special conditions imposed by local councils can be punitive if not allowed for in capital budgeting. Budget for more and costlier pre-launch marketing to make sure sales reps have enough leads and order flow to keep them productive from Day One. Consider using contract employees, at least at first, to keep costs low and flexibility high.

Build systems

Like castor oil given to a young child, business people will take a dose of common sense only if it is forced down their throats. Now may be the time to do just that if you are still operating under the delusion that your business is merely offering you an occupation. If your business is starting to feel more like owning a job – a bad job – than a business then it's time to find a new way of doing business. But how do you make the switch?

Working in your business means you are constantly putting out fires. Most successful business people will tell you that success is not so much a question of the business generating good profit (that's certainly great) but rather the ability of the business to function without your presence there 12 hours a day and six days a week. Success is the ability to have a life outside your business as well as having a profitable business. Obviously systems and procedures are going to have to be documented – indeed, fool-proofed – for this to be realised.

Perfect processes will produce perfect results

This is sometimes known as the McDonald's Principle, or McDonald's Effect. Until McDonald's first hit the market under the guiding hand of former milkshake machine salesman Ray Kroc, no one had previously unleashed the power of a business system so perfectly crafted that it required no tinkering, no debugging, not trial and error.

The McDonald's Effect is a phenomenon made possible by the vision of Ray Kroc who saw that a well-oiled business, such as the one run by the McDonald brothers in San Bernardino, California, could be expanded into a viable franchise with thousands of different owners. Kroc perfected every detail of the McDonald's procedure in a prototype store. Taken to its ultimate conclusion, a perfect system and set of procedures has the ability to replicate itself thousands of times – as McDonald's exemplifies.

For business people planning to grow beyond their personal management style or limitations, this concept is well worth understanding and appreciating.

Ray Kroc understood that in order to make money out McDonald's there had to be systems and procedures in place to allow replication of this proven operation. Neither Ray Kroc nor the McDonald brothers could become the key workers. There had to be a prototype that could then act as the model for replication and expansion. For the business to thrive, Ray Kroc had to put in place not just systems and procedures, but employees and some organisational structure around them. If McDonald's was going to thrive Ray Kroc had to find other people to do the work. But once the prototype was effective, Ray Kroc and the McDonald brothers would no longer work in the business. In effect, the employees do the technical work – both manual and managerial – and the owners are left to do the strategic thinking.

Of course the Kroc approach is not restricted to a food retail store – it can be applied to virtually any business case. An effective prototype is not just a well-oiled machine but it is a business that finds and keeps customers – profitably – better than any other model of the business, i.e. its competitors. And then the prototype is put in the context of a larger, expanded business.

The turnkey solution

When you buy a new car, you don't expect to have to open the bonnet and fiddle around with the bits under the bonnet. You should just turn the key and start driving. That's what the word 'turnkey' means. In the business world, it refers to a system so perfectly crafted that it requires no debugging or fiddling with, or any sense that things won't work from the outset. Just turn the key, and start making money. If your business is starting to feel more like a rut than a business then it is time to find a new way of doing business: the turnkey approach.

A turnkey system is any method or procedure that simplifies or automates part of the business, making it easier for ordinary people to operate.

Just as McDonald's stores have replicated themselves tens of thousands of times over around the world, a business run itself on a turnkey basis if it has the right systems and procedures in place.

This systems approach to business allows a small business owner the means to finally integrate his activities via a set of systems and procedures. For a manager, the systems approach provides the order, the predictability that is so important to the running of his or her business. For a proficient technical specialist or professional business operator-owner, it provides the opportunity to have systems and procedures attended to by other people, so that he can be free to the things he loves to do – the 'technical' work or the strategic work.

How do you build a business that works without you?

Every business has its own unique characteristics but there is always a kind of flow of work that goes to make up the overall business.

Your task as the business owner is to identify and build your own systems. These systems need to be written in the form of a 'procedures and tasks manual' (sometimes these are called 'operations manuals'). Every segment of your business has definite procedures that make up the work flow. These procedures must be totally consistent with the strategic goals of the business that have already been set.

Inevitably this will involve some tedium. Each person involved will have to, in a sense, go over other people's domains. Sometimes it is not possible for the incumbent in a particular role to see beyond the current practices. That's okay. This is not a test. But it isn't entirely tedious: this can be an exciting time in which everyone can share the burden and, hopefully, the excitement.

Developing procedures

Just because you are armed with a business plan or a set of strategic goals does not mean that running your business will be any easier. There is work to be done to get the systems, procedures and organisational structure right. Ray Kroc sweated over this for a considerable time before he was confident that a franchise operator could come in and switch on the lights and power and deliver the same high-quality hamburger time and time again. Every detail of the business has to be handled: examined, improved, documented.

Up to now, whether it's making a sale, negotiating with a supplier, or keeping track of expenses you, as the business operator, have just got the job done. This is fine if the business is just you. But when there has been growth and you are ready to go into 'systems and procedures' then a change is needed.

This exercise requires all key people to be involved. It requires each person to ask the questions 'What would best service our customers here? How could I streamline or change the practices in order to give the customer what they want most easily while at the same time maximising profits?'

To help kick off this systems and procedures process, ask yourself how your business, for example, bills the customers, handles customer complaints and determines employee remuneration packages.

Steps to developing a procedures manual

Each business owner will have their own style in implementing new business initiatives, but when it comes to identifying all the elements of the business, there can be no better opportunity for a team effort.

Once the decision has been taken to go the systems way, how do you kick off the process? Start with the goals of the business, breaking these down into a series of procedures and tasks:

- Set up a systems 'office'. This can certainly be a virtual office but there is a need for a central place where the people involved can meet.
- List (or set) strategic goals.
- Identify tasks necessary to achieve the goals.
- Develop effective procedures to achieve the tasks; that is, write the procedures manual that replicates the prototype.
- Build confidence: it's important to get a systems design completed early to add momentum to the process. This will support confidence among management, staff and external stakeholders. It's about putting some runs on the board.
- Identify transitional systems: it would more good luck than good management to expect everything to go the systems way simultaneously across the organisation. There would, more than likely, need to be a staged transition to allow for the slower areas to be implemented and for re-training to be effected where necessary.
- Create the desired 'turnkey environment'. What worked in a pre-turnkey era may no longer work. There may be a shift not just in job descriptions but also in working hours, flexitime, meeting times, etc.
- Explain the new turnkey strategy. All key employees and stakeholders need to be told what is happening and when.

What inevitably comes up in this process is both simplification – it's finding a better way of doing things – and also new roles. This may require a training effort. The ultimate goal of imposing structure and instituting systems and procedures is, of course, predictability. A system is any method or procedure that simplifies or automates part of the business, making it easier for ordinary people to operate it. As one business owner put to me: 'I've set systems in place – the policies and procedures – documented down to every task so that staff know exactly what they are to do and how they are to do it, and how they are accountable for doing it well.' She went one step further and ensured that the business invested energy and money towards training. 'Because some of the tasks will be new tasks. Then we train and train them all over again.'

Measuring the results

Unless a business owner can pinpoint where his business is today and can project where it's going to be this week, this month; this quarter and this year, it's not on a trajectory for growth. In fact, it might not be on track for survival. This is where those financial reports can be worth their weight in gold. Far from being a mere nuisance compliance job; financial reports are like the dashboard of a car: you can't drive without them.

Letting go

Going the systems way is more often than not the time for reappointing yourself as something other than the CEO or managing director. Sometimes letting go of your business's reins is the only smart choice. That doesn't mean you have to like it. The usual refrain is, 'This is my business. I'm the founder and the CEO. I created the entire business out of nothing. I was the one who stayed awake at night in the early days, worrying about paying staff and collecting on my invoices.'

When the decision is taken to let go the reins of controlling every aspect of the business, there are bound to be convulsions. Giving appointed managers the nod to run the business with their personal authority intact means no peeping over their shoulders as a way of keeping a tether between you and your 'baby'. You too will need to learn to follow the systems and procedures that are to be put in place. It's time to break yourself of old habits – and it may be hard to do so.

Don't be surprised if you find yourself resisting or putting off delegating authority to the management team for as long as possible. After all, who wants to give up being the chief cook and bottle washer of their own business? But if the business has grown well beyond the start-up stage, it will almost certainly demand new things you aren't able to provide. So there will inevitably come a time to take yourself out of the chain of command, put a management team in charge and, where necessary, bring in outside consultants to help develop the systems needed to keep the company healthy over the long haul.

Transitions

The fact is – like it or not – the business and its people are probably ready for this change well before you are, psychologically speaking. People need order, structure and predictability; they need to know what they are walking into when they come to the office each day.

Some business owners thrive on the problem-solving side of being in business. It keeps them keen and activated; the challenge can be pleasurable to people going into business … you're juggling a dozen balls and you run on pure adrenaline. It's exciting and stimulating. But that's really only ephemeral. Mostly business has to be more predictable and organised. A business eventually reaches the point at which it can sustain itself on its own cash flow and, when it gets there, it moves away from that critical infancy stage with all the problem-solving challenges and begins to develop a whole new set of needs – management, stability and structure.

It comes down to one word: delegation. But delegating authority doesn't always come easy: it's very difficult to change the way your business is run – going from one-person rule to professional management.

The first challenge may well be to find someone else to manage the transition to professional management for you. This is not to say you must seek out a new CEO, but it does mean a new management system. If your strengths do not lie in convening or facilitating meetings – for example, running a staff meeting with 5, 7 or 10 people discussing how things should be done – then it may be better for someone else to lead the process. This could be a manager type, or

a consultant type; there are consultants who specialise in such transitions. After all, if you are an entrepreneur, a long-range plan is a week; for a manager, a short-range plan is a year.

The second challenge you may be facing over this transition is to redefine your role in the business. If you aren't going to be running the business any more, how are going to spend your time? You will certainly want to stay involved, but you will have to get out of the way. You may have trouble accepting that people can make decisions without you.

The whole exercise is about taking the chief-cook-and-bottle-washer and making him or her into something else. It is vital not to lose track of what that 'something-else' role is in the business. Identify your strengths and play to them. If you are good at sales be the face of the business to the key customers. If it is product development, roll your sleeves up and become involved in sussing out market opportunities and checking the customer base for its needs. Perhaps there's an export market that needs some investigation? Get on a plane and speak to the key people.

Have an exit strategy

Drive, charisma, ambition, determination, passion are some of the qualities that allow businesspeople to grind down opposition, surmount near-impossible hurdles and conquer new markets. You own a business to make profits and that's its fundamental purpose. But just how much makes this superhuman effort worthwhile? Most business owners go into business not only to earn an income, but, importantly, to build the value of the business and to sell at a profit. That's a noble ambition for sure but that could be five, 10 or even 20 years away.

How do you balance the needs of a capital hungry business with the need to having a living income? Here, it's not entrepreneurship but rather sound, personal financial management which presents solutions.

Chris Gorman, chief executive of membership organisation The Executive Connection (TEC) says that members often have an overly optimistic view of how much their business will be worth on the final payday, when they sells. TEC, which acts as a think tank for chief executives, managing directors and business owners of small to medium sized businesses who get together on a monthly basis in groups of 16, has a wide membership covering law firms, manufacturing companies and service businesses.

Many business people had clear and stated objectives for their businesses, but few have any defined personal financial goals. If there were any personal goals they were almost always subordinated to the business objectives. Many think they can rely on the value of their business when they sell it to give adequate return on their efforts. The problem is that there is no guarantee a business will be worth anything, much less what an owner expects, when the considering selling the business.

Scaling a business

Can a small niche business ever achieved a multi-million dollar value? Yes, consider these three illustrations which were selected because the business owners, from the outset, set out to build something bigger than "a job". From portable toilets to online natural therapy directories, these niche businesses have the potential to generate big dollars if they capture the hearts, minds and wallets of a dedicated consumer base. Even an online retail department store is a niche business focussing on a single channel of selling. Niche businesses, rather than limiting a small business can indeed present as an ideal model for growth. Becoming a big fish in a small pond can be big business.

Jim Noort, founder of Viking Rentals, a supplier of portable toilets, says that he's in the equipment hire business. "Portable toilets are a niche category. I learned that it's really difficult to build new markets. Market forces are working against you. It's best to try and get into an established marketplace, not necessarily with a world–first

product. Maybe there's something that's already there, but just do it a bit better; where you don't actually have to explain to the customer what the hell it is you're selling." He says it's about innovation and service in an industry dominated by large, national companies who are "locked in" to their established way of doing business. "You need a differentiated product."

Growth is built on acquiring customers, geographic expansion and acquisition of smaller, less efficient competitors. Venture capital investor Mark Sowerby says that a niche business can be attractive to venture capital investors. "They've got to be able to steal market share and the business has to be scalable. We like industries where the dominant incumbents are locked in to established infrastructure and where our operator can turn the model on its head."

Sowerby observes that, often in an industry it is the first tier operators, usually national brands, which are locked in to their established infrastructure. "They have multiple products. When you have a disruptive, niche entrant like Viking come in and turn the (established) business model on its head, then they may not necessarily respond. They may put their capital elsewhere."

Directories as a case study

For online directory operator, David Vitek, a small base allowed him to establish a scalable model without the burden of large overheads or infrastructure. In 2004 Vitek founded Natural Therapy Pages and Home Improvement Pages, directories which listed service providers for a fee. His 90-strong team now support directory lists in Australia, New Zealand and the UK. The directories enable people to connect with service providers in their local area. "They are among Australia's most popular specialist directories," notes Vitek.

He says growth is about fine-tuning your brand, website, and marketing tactics to focus on new opportunities. "The natural health industry is a niche category. But I knew that if people become more interested in their health and wellbeing, their needs for information would grow." Vitek says the niche opportunity can be expanded. "You can expand the business internationally once your model is functioning profitably. We saw the UK as being an opportunity for us and used NZ as a test for our expansion model. We saw we could export the model."

Vitek points out that each country will have its particular market characteristics. "Systems and procedures were the same, but we had to adjust price points. You set up a 'copy' corporate structure (in the other country). It's relatively seamless to set up a local customer service centre from Sydney as well as a telemarketing sales team. It's about managing time zone difference. You consider the accent too but we went with the greeting "we're calling from sunny Australia'. It's worked well.

"There is an investment need when moving to more sizable scale. You invest in more resources to the core. You can gain good efficiencies from admin such as credit card processing, accounts receivable, marketing and sales."

A nice market

A niche marketplace is a small, specialized market segment within a larger, viable commercial industry. For Paul Greenberg founder of online retailer Deals Direct, his niche is the online, single channel. He says the key to success online is to offer exceptional service and to eliminate any uncertainty about buying goods online. "You might imagine that online offers some kind of silver bullet. Not so. It's the same as off line; you grow one customer at a time." With more 600,000 customers and 6,000 products across 26 consumer categories Greenberg appears to have successfully taken the niche operation to a significant medium-sized player in the sector.

“A lot of entrepreneurs start their retail journey with a small high street store and then slowly grow their footprint. We also started small. There’s been no blue sky for us. We’ve seen what seemed like fantastic businesses come and go around us. We’ve held our course. We’re online retailers, it’s the one channel. And what defines a good retailer is a hundred things you do well.” He says the company has invested in compiling data to produce a detailed profile of the target customer to enable targeted growth.

The takeaway? Niche operators are highly effective users of customer profile data (see Know Your Target Market) and work very hard at continuously improving and investing in their core business. Small, niche businesses can leverage their successes by staying very close to – indeed in many cases replicating – their simple service.

Plan five years head

It is sad fact that an asset is worth considerably more when you control the timing of the sale. If your exit is planned then you have the comfort of maximizing your sale price by selecting the type of buyer who may be willing to pay a premium for your business.

Whereas a business “for sale” through a business broker or The Australian Financial Review tends to bring what is referred to as a ‘financial’ buyer (that is, someone who wants a financial return on the business on a going-concern basis), an optimal exit price is usually achieved by seeking out potential ‘strategic' buyers. Unless you have a business which is loosely referred to as a ‘lifestyle’ business – for example a B&B, a cafe, an online retail business – then the strategic buyer is worth his weight in gold.

If you read the financial press you will see how strategic buyers, for example media companies buying strategic assets of smaller business such as social networking websites, or large retailers buying niche retail chains.

The reason the big companies are prepared to pay large premiums is because they have worked out how to generate many times the revenue and profit of the seller. They achieve this, typically, by selling the seller’s product or service through their own distribution channel, which is likely to be 10s, if not 100s, of times the size of the seller’s.

Financial sales, on the other hand, only represent what the seller’s business can achieve on its own. Even if this has significant potential, it will fall a long way short of what a national or global corporation can achieve with the same product or service. So the business that sells to a financial buyer is lucky to get several times EBIT for its business whereas the strategic sale can often generate large multiples of EBIT or many times revenue.

A strategic sale strategy

The key to a strategic sale is to provide a large corporation something that can generate large incremental revenue through the buyer’s existing distribution channel or to enable the buyer to open up new markets for significant revenue. The basis of such an opportunity lies in exploiting an asset or capability the seller has.

The opportunity for the large corporation is to throw significant resources at leveraging the asset or capability where short term revenue can be readily generated.

Even if longer term opportunities exist, the short term revenues are the ones that will justify the premium on sale.

The task of the business owner is to identify those assets (distribution channels, patents, trademarks, licenses, copyrights, brands, customer base, locations, specialized plant, deep expertise and so on) or capabilities (the things

you do that you do exceptionally well) which a large corporation could exploit. And to build their business from an early stage with this in mind.

A key factor in this stratagem is the systems (which we looked at earlier in the book) and management team that have been built in the business which ameliorate the role of the founder in the sale equation.

At the same time, you need to build protection through patents, brands, trademarks and expertise to slow down the erosion of the competitive advantage that the buyer is acquiring.

Strategic value does not depend on your profitability or growth. Even size may not matter if you can provide the right scalability capability. Remember a strategic buyer will be running the slide rule over the scalability of the current business not the current revenue.

Often a misnomer, succession planning is usually done in response to the onset of health issues regardless of how big or small the enterprise is. When you consider the average age of family business owners today is 56 years, it is therefore reasonable to assume that for many, retirement is not too far off. Yet most have no real succession plan.

The family business

According to MGI Melbourne principal, Sue Prestney the potential, underlying impact on family wealth is daunting.

Australia's two million family businesses are valued at up to $1.5 trillion, representing around 97 percent of businesses in Australia and employing the majority of the workforce. Ms Prestney says the GFC has shifted priorities of business owners. "Pre GFC there was an emphasis on business sale as an exit strategy. It was a reflection of the crazy prices being paid. Today, few owners are looking at selling as an exit option. The prices just aren't there."

The MGI Australian Family and Private Business Survey 2010 was undertaken by RMIT University and supported by MGI, an international accounting firm specialising in advice to family and privately owned businesses.

The survey among 5000 Australian companies by Professor Kosmas Smyrnios revealed that, apart from fewer owners considering selling their operation if approached, a higher percentage of owners said they did not have an enough funds for retirement due to the reduced investment values. It also found that percentage of owners with concerns about the future financial performance of the family business jumped from 31 per cent to 54 per cent and that about half of owners said they would still be working beyond 65 years of age with one third saying they needed the ongoing income or to sell the business to fund retirement.

"They are being realistic. They are staying in the business longer. A lot more will be relying on releasing value from the business in order to give themselves adequate retirement funding," says Ms Prestney.

It is clear that a vast number of business owners are not prepared for their succession and will end up making decisions at the last minute, with the likely outcome to be a poor result not only for the business owner, but the clients, suppliers and staff also. Ms Prestney says that families are not always ready for a succession. "When you sit down to have a family meeting there is often upheaval, so they put it off."

Most business owners go into business not only to earn an income, but, importantly, to build the value of the business and to sell at a profit. For many, the value locked-up within their business is their second largest asset behind the family home, and in some cases it is even more valuable than the family home.

A family paradox

It is a curious phenomenon of the psychology of wealth that business owners often spend little time thinking about investing, arguing (perhaps to themselves) that their business which they control and pull the levers in, is a far better investment than a portfolio of shares where you have no control over the outcome. While most people will happily invest time, effort and money planning for the sale of their home, they don't do the same with their business. Choosing to invest the time and effort to develop a strategic business succession plan is nothing more than another investment activity in personal wealth management.

Rather than something back of mind, succession planning indeed, amplifies the ability as a business owner to extract the maximum amount of value from the business upon exit. The problem is many business owners have an overly optimistic view of an exit.

Most begin with a grand vision; most will have a vague notion of a trade sale, a management buy-out or even an IPO. Few ever achieve any of these. For most, the exit plan is analogous to the making of a last will and testament. The risks of staying too long are high as evidenced by diminution of value over the duration of the GFC which reduced available funds for an adequate generational buy out.

There is more fundamental issue at stake: succession planning is a tool. In effect, a succession plan can trigger implementation and refining of systems and processes to the point that the business can run just as well without the owner as it did with them at the helm. Often relegated to the wish list, the task of documenting every activity undertaken in a business should mean business as usual under all circumstances.

Even beyond thinking of retirement, business succession planning must also be considered from the point of view of business continuity should anything unexpected happen to you. In the event of your death or serious illness, what would happen to your business? Do you have plans in place to ensure that control or ownership of the business is passed on to the successor of your choosing? And would your family be taken care of in the event of the business being sold?

For many people, the value locked-up within their business is their second-largest asset behind the family home, and in some cases it is even more valuable than the family home. Yet most people invest more time, effort and money planning for the sale of their home than they do for the sale of their business. Investing the time and effort to develop a succession plan which ensures that you realize the maximum amount of value from your business when you retire, or if the unexpected should ever happen, is one of the most important financial decisions you will ever make.

Unlocking the value of the business

A key element in your succession plan is ensuring that the value of your business is maximized when you're ready to sell. This takes time; it cannot be done overnight and it cannot be done without proper planning Determining the accounting value of your business.

Accountants will tell you that while there are many ways to value a business, most are based on some measurement of past profit and a determination of what that profit is worth in 'today's dollars'. Most business valuations involve an assessment of the:

☐ Industry in which the business operates

☐ Business risks and future prospects

☐ Profitability, cash flow and financial position of the business (and how well the financial records are kept).

The most commonly used valuation methodologies are:

☐ Liquidation or net realizable value

☐ discounted cash flow (net present value of projected future cash flows)

☐ Capitalization of future maintainable earnings

☐ Investment value.

Liquidation or Net Realizable Value

This method of valuation is based on what price could be achieved if all of the business's assets were to be sold. For businesses that are planning to continue, this method simply provides an indication of 'minimum value' since it does not take into account any of the business's actual or potential earnings. As a benchmark, the assets employed in a business should generate more in earnings and cash flow than they would if they were to be sold.

Discounted Cash Flow

This method of valuation seeks to calculate the present day value of the business's projected future net cash flow. It requires an analysis of future cash flow, capital structure, the costs of capital and an assessment of the value of the business at the end of the forecast period. Forecasts, by their nature, are inherently uncertain as they are necessarily based on assumptions, many of which are beyond the control of the business and/or its management. The actual future results may be very different to those forecasted, and as a result, this method is not popular, although it is often used to estimate the value of start-up businesses.

Capitalization of Future Maintainable Earnings

This method determines a valuation range based on the capitalization of future maintainable earnings. It is appropriate for businesses that:

☐ are a going concern

☐ have been in existence for a number of years

☐ are not undergoing any significant transformation

☐ have historically stable profitability

☐ are not likely to experience significant growth or decline

☐ have products that do not face technological obsolescence.

Investment Value

On occasion a buyer that believes they will enjoy post purchase economies of scale, synergies or strategic advantages by combining the purchased business with their current business, will place an 'investment value' on the business which differs from 'fair market value'. Investment value is based on the specific value of a business to a particular buyer.

As you can see, many of these valuation techniques are largely based on profit, so how do you improve your profits? First, by using the boutique and scale based methods of increasing 'premium' or 'volume', and second, by strategically managing growth, capacity and risk.

Businesses that take a strategic approach to managing their capacity (that is, how much business they can do, with what types of clients, using what mixture of resources) and growth are typically more profitable over the longer term.

As with any major business strategy, designing and documenting is ultimately only a small component of success. The key to effective succession planning is communicating and implementing the plan over a long period of time. While many businesses do invest time, effort and money designing and documenting a succession plan, they fall short when it comes time to communicate the plan to staff and other stakeholders.

When implementing a succession strategy, given that we are talking about a project that may run over several years, consistency is important. Properly prepared documentation will help to make the implementation phase much easier. The involvement of a team of expert advisers throughout the project can help to ensure a smooth process over a long period of time.

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