

Growing to death

Growing to death is a common form of business failure. How could it be that a business with excellent sales revenue and a strong history of growth fails? Inside this month, we explore the dangers and the warning signs.

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 more 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 any more 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 big new client can be your business's ruin but its 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 part of the vocabulary. 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.

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Couple fined for breaching SMSF rules

The trustees of a self managed superannuation fund have been issued penalties of \$30,000 and ordered to pay \$32,500 in costs for breaching the rules relating to their fund.

In a further warning to Trustees of self managed superannuation funds (SMSF), the penalty highlights just how easy it is to cross the line.

Mr and Mrs Fitzgeralds, a Queensland couple running a business did what many business operators do; they established a SMSF with the company as trustee. The company then purchased a commercial property. Title to the property however was registered in the name of the company without specific reference in the title register to its ownership in the capacity of trustee. Despite this, the property was the principal asset noted in the financial statements of the fund. Following the purchase the couple then became Trustees of the fund.

Unfortunately for them the company got into financial difficulty and earlier this year, the Supreme Court ordered the company be wound up. The liquidation left the couple with a debt of \$129,994 of which they paid \$30,000 in partial satisfaction of that claim (the liquidator accepted that the commercial property was the property of the fund and not the company).

Just prior to the partial payment, the fund paid Mr Fitzgeralds \$12,000 and soon after another sum of \$23,000.

Late that month the liquidator caused the commercial property to be sold. The \$155,000 sale was procured by the Fitzgeralds as trustees of the fund. By arrangement with the liquidator, the proceeds of the sale were dispersed to the liquidator in final settlement of the debt and the remainder to Mr Fitzgeralds.

Growing to death *continued*

Let's look at a recent 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.

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!

We don't want to put you off seizing opportunities when they arise. We do however want to ensure that the opportunity is financially sound and that you make the most of it. Growth is great, but it needs to be managed. Speak to us today about working with you to establish your businesses key financial drivers and considerations. Feel free to talk to us at anytime about opportunities as they arise.

Couple fined for breaching SMSF rules *continued*

Mid October the Federal Court found that the Fitzgerald's contravened Section 62 (1) of the *Superannuation Industry Supervision Act*. That is, the couple had accessed assets in the superannuation fund before meeting any conditions of release such as retirement or reaching preservation age. In addition, the Court also found the couple contravened section 65 which prevents the fund giving financial assistance using the resources of the Fund to a Fund member.

In effect the \$115,000 property transaction and the extension of the loan cost the couple an additional \$62,500.

If you are uncertain about what you can do with the assets of your superannuation fund, talk to us today or visit the Tax Office website at www.ato.gov.au where you will find a range of information and guides to assist trustees.