TOOLKIT 33 – KEEP YOUR FINGER ON THE FINANCIAL PULSE OF YOUR BUSINESS

- **Manage your key financial indicators.**
- **Control your cash.**
- **Manage growth.**

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For many businesses finance and accounting tends to be left to banks and accountants. By leaving your numbers to the 'experts' you may be missing a trick or two. You may be even giving up control of your business.

As the Manager of any business you need to know what makes your business profitable (or not) and how to have enough cash available to pay bills at the right time. If your business is growing you want to know how much extra cash you will need and where to get it.

You need to understand the financial consequences of your business decisions on the financial results of your business overall.

Here's how to do it

STEP 1 Manage breakeven sales

Breakeven sales are simply the sales value you will need in any period to cover all your business costs.

Breakeven sales analysis helps you to get maximum profits (or minimum losses) by focusing on the three key figures that decide your profit or loss. These are:

- **Sales**

- **Gross profit as a percentage of sales**

- **Fixed costs (expenses or overheads)**

To examine your breakeven you use the following:

- Variable costs (nearly always described in your accounts as cost of sales) –these are costs which go up as your sales rise and go down if your sales fall e.g. materials.

- Fixed costs (probably described in your accounts as expenses or overheads but other terms are used) – these are costs that stay the same whether your sales go up or down e.g., rent.

- Gross profit – this is the monetary difference between the value of your sales, and the cost to you of buying or manufacturing the goods you have sold.

- Gross profit percentage (often described as gross margin or gross margin percentage) – this is your gross profit divided by sales multiplied by 100.

- Your 'breakeven sales point' is the level of sales you need to make for your business to 'breakeven' (so that it makes neither profit nor loss). It is important to know that your 'breakeven sales point' will change over time because of the way it is worked out.

  You can work out your breakeven sales point every day, every week or every month.

- Before you can work out your breakeven sales you need to work out your gross profit percentage:

  Example:

Selling price	£100,000
Less Variable costs	£ 60,000
Gross profit is	£ 40,000

  Your gross profit percentage is:

  Your gross profit divided by your sales and then multiplied by 100.

  This is

  $$\frac{£\ 40{,}000}{£100{,}000} \times 100$$

  giving a gross profit percentage of 40%.

  We can now use this information to work out your breakeven sales.

  Your breakeven sales point is:

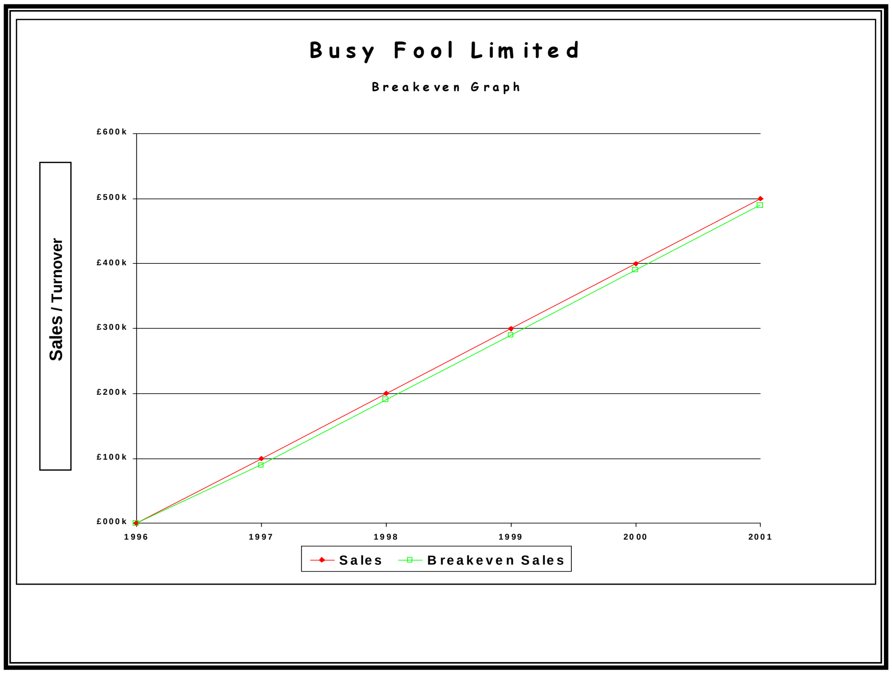
  Your fixed costs divided by your gross profit percentage and then multiplied by 100.

  Using the gross profit percentage of 40%, and assuming that your fixed costs are £30,000:

  Your breakeven sales are:

  $$\frac{£30{,}000}{40\%} \times 100$$

Plotting breakeven sales in relation to sales on a graph is the simplest way of gaining an insight into the profitability of your business. Ideally breakeven sales should be held constant or even be reduced whilst sales are increasing in a controlled and incremental fashion. In any business where breakeven sales are increasing at the same rate or a higher rate than sales, then you may be operating like the proverbial 'busy fool'. This means that you are working increasingly hard to make the same level of profits that were generated at lower levels of turnover whilst at the same time the need for cash will be increasing putting further pressure on the business.



Using breakeven to improve your business

If you compare your actual sales with your breakeven point, you will be able to see whether you are:

- making a profit (your sales are above your breakeven sales point) or

- making a loss (your sales are less than your breakeven sales point) or

- just breaking even (your sales are equal to your breakeven sales point).

There are three things you can do to increase profits or reduce losses:

1. Reduce your breakeven sales point while keeping actual sales the same.

2. Increase your sales while keeping your breakeven sales point the same.

3. Reduce your breakeven sales point and increase your sales at the same time.

You can reduce your breakeven sales point by:

- Improving your gross profit percentage by increasing prices and/or reducing variable costs (cost of sales).

- Reducing your fixed costs by cutting your overheads. See toolkit 32 'Fighting the flab'.

- Reviewing your product mix – that is devoting your resources towards selling more of those products or services, which produce the highest return. See toolkit 9 'Redoing your strategy'.

Improving Gross Profit %

All businesses should try to improve their gross profit percentage through modest price increases and reductions in the cost of sales. Unfortunately the most frequent reaction during times of difficulty is to reduce prices with a view to generating additional sales income. This ignores the simple fact that the whole of any price reduction must come out of the profit. This is best illustrated by reference to the Price/Volume Dynamic Ready Reckoner.

Cutting Prices
Percentage that sales must increase to maintain current gross profit

Current Gross Profit Percentage								
Price Cut %	10%	20%	25%	30%	35%	40%	45%	50%
-2%	25%	11%	9%	7%	6%	5%	5%	4%
-3%	43%	18%	14%	11%	9%	8%	7%	6%
-4%	67%	25%	19%	15%	13%	11%	10%	9%
-5%	100%	33%	25%	20%	17%	14%	13%	11%
-10%		100%	67%	50%	40%	33%	29%	25%
-15%		300%	150%	100%	75%	60%	50%	43%

Example:

A business achieving a 40% gross profit which cuts prices by 10% will need to generate 33% additional sales before starting to improve on the pre-price-cut trading position. This could be catastrophic, as the hardest thing to generate during a recession or times of adversity is additional sales. Then you have to consider if the additional level of activity required is feasible with existing physical resources and if you have enough cash available to cover the additional working capital required.

Increasing Prices
Percentage that sales can fall before total gross profit reduces

Current Gross Profit Percentage								
Price Increase	10%	20%	25%	30%	35%	40%	45%	50%
+2%	17%	9%	7%	6%	5%	5%	4%	4%
+3%	23%	13%	11%	9%	8%	7%	6%	6%
+4%	29%	17%	14%	12%	10%	9%	8%	7%
+5%	33%	20%	17%	14%	13%	11%	10%	9%
+10%	50%	33%	29%	25%	22%	20%	18%	17%
+15%	60%	43%	37%	33%	30%	27%	25%	23%

Example:

If a business with a 40% gross profit margin increases prices by 10%, it can afford to lose 20% of volume without suffering any reduction in profit levels. If sales fall by less than 10% then the business is generating more profit, without anyone having to work any harder. At the same time the reduction in sales will take the pressure off resources and free up cash previously tied up in working capital.

TIP: Know why your customers buy from you rather than your competitors – it is unlikely to be price alone. Conduct a customer perception survey to identify why your customers buy from you (toolkit 16).

Calculations based on our earlier example:

Sales	£100,000	
Variable Costs	£ 60,000	
Gross Profit	£ 40,000	(40%)
Fixed Costs	£ 30,000	
Net Profit	£ 10,000	(10%)
Breakeven Sales	£ 75,000	

The effect of increasing price

If you increase the selling price by 10%, sales income will increase from £100,000 to £110,000 whilst variable and fixed costs remain the same. Accordingly gross profit will increase by £10,000 from £40,000 to £50,000, gross profit percentage will increase from 40% to 45.5%, breakeven sales will fall from £75,000 to £65,934 and net profit will double from £10,000 to £20,000.

This is illustrated below:

Sales	£100,000	£110,000
Variable Costs	£ 60,000	£ 60,000
Gross Profit	£ 40,000 (40%)	£ 50,000 (45.5%)
Fixed Costs	£ 30,000	£ 30,000
Net Profit	£ 10,000 (10%)	£ 20,000 (18.2%)
Breakeven Sales	£ 75,000	£ 65,934

If prices are increased by 10% and sales remain constant then net profit will increase by 100% and breakeven sales will fall by 12%.

TIP: Avoid trying to stimulate turnover by cutting prices as you will almost certainly find yourself suffering from the 'busy fool' syndrome.

Reducing variable costs (cost of sales)

So far we have only looked at the effect of a change in price. Another possibility is to reduce variable costs which is also known as "value engineering". Most businesses can re-organise their operational processes to reduce the labour and material content of production. See for example, 'Fixing system slippage' toolkit 28 and 'Removing process blocks and disconnects' toolkit 29. Cumulatively, small changes and marginal trimming can be extremely significant and bring about significant results. The combined effect of cost reductions and effective pricing can substantially improve the financial performance of any business.

Using our example again if you reduce variable costs by 10% they will fall from £60,000 to £54,000. Accordingly gross profit will increase by £6,000 from £40,000 to £46,000, gross profit percentage will increase from 40% to 46%, breakeven sales will fall from £75,000 to £65,217 and net profit will increase £6,000 to £16,000.

This is illustrated below:

Sales	£100,000	£100,000
Variable Costs	£ 60,000	£ 54,000
Gross Profit	£ 40,000 (40%)	£ 46,000 (46%)
Fixed Costs	£ 30,000	£ 30,000
Net Profit	£ 10,000 (10%)	£ 16,000 (16%)
Breakeven Sales	£ 75,000	£ 65,217

If variable costs are reduced by 10%, net profit will increase by 62.5% and breakeven sales will fall by 13%.

STEP 2 Controlling gross profit

Gross profit is the difference between the value of sales for a specific period and the variable costs the business incurs because of those sales. These costs will be described in your accounts as cost of sales.

This difference or gross profit is what your business has generated in order to pay for the fixed costs of the business such as rent, rates, your salary, salaries of managers, telephones, stationery and so on. Anything left over is net profit for the business.

Once you have met your variable costs:

- If your gross profit is not enough to pay for all the fixed costs of your business then you have made a loss.

- If your gross profit is just enough to pay for your fixed costs then you have broken even.

- If your gross profit is more than enough to pay your fixed costs then you have made a profit.

- If you are in control of your gross profit then you are in control of one of the key factors which directly affects how profitable your business is. (The others are sales and fixed costs.)

  Your aim is very simple – you must get your gross profit in £ as high as possible for your product or service. If you can do this, you are more likely to be able to pay all your fixed costs and earn a net profit as well.

STEP 3 Control fixed costs

Fixed costs are those costs, which your business will continue to incur for some time even if you stopped making or selling your products or services today. These include rent on your premises, business rates, insurance and many others. Do not forget to include any interest paid here.

There are lots of views on what is and what is not a fixed cost, which makes it very confusing for everyone, even the accountant. The best way of dealing with this particular problem is simply to be consistent in how you split your costs because you will then be able to accurately compare key trends within your business.

> TIP: When looking to cut fixed costs focus on "good housekeeping" but be careful not to fundamentally damage your business. It will still be necessary to invest in the research and development of new products, new processes, new markets, the introduction of new technology and to invest in your staff if the business is to prosper in the long term.

If you reduce fixed costs by 10% they will fall by £3,000 from £30,000 to £27,000. Accordingly, the gross profit and gross profit percentage will remain unchanged, but breakeven sales will fall from £75,000 to £67,500 and net profit will increase £6,000 to £16,000.

This is illustrated below:

Sales	£100,000	£100,000
Variable Costs	£ 60,000	£ 60,000
Gross Profit	£ 40,000 (40%)	£ 40,000 (40%)
Fixed Costs	£ 30,000	£ 27,000
Net Profit	£ 10,000 (10%)	£ 16,000 (16%)
Breakeven Sales	£ 75,000	£ 67,500

If variable costs are reduced by 10% net profit will increase by 30% and breakeven sales will fall by 10%.

TIP: Consider completing the 'Fighting the flab' toolkit 32 in order to attack and reduce your fixed costs.

TIP: Try to make as many fixed costs as variable as possible e.g. pay your PR company for projects not a retainer.

To improve profitability and reduce breakeven, increasing prices and reducing variable and fixed costs is a winning combination. Let us see the cumulative effect of a 10% increase in price and a 10% reduction in both variable costs and fixed costs.

This is illustrated below:

Sales	£100,000	£110,000
Variable Costs	£ 60,000	£ 54,000
Gross Profit	£ 40,000 (40%)	£ 56,000 (50.9%)
Fixed Costs	£ 30,000	£ 27,000
Net Profit	£ 10,000 (10%)	£ 29,000 (26.4%)
Breakeven Sales	£ 75,000	£ 53,045

The combined result of these changes is that net profit has increased by £19,000 to £29,000 (up 190%) whilst breakeven sales have fallen by £21,955 (down 29%).

KEY POINTS

All businesses should focus on improving their gross profit.

Gross profit is the small number, which is the difference between two large numbers, sales and variable costs (costs of sales). Small changes in the large numbers will lead to large changes in the small number.

The combined effect of 'value engineering' (reducing cost of sales) and modest increases in price will substantially improve the profitability of any business.

The whole effect of any reduction in price can only come out of the gross profit. The sensitivity of the price : volume relationship must always be a prime consideration.

A growing business is only 'better off' by the additional profit or contribution, not additional turnover.

STEP 4 Control cash

To stay in business today and in the future your business must be generating enough cash to pay the bills at the time when they have to be paid. Unless you have enough cash available, it does not matter how 'profitable' your business is, because the people you owe money to (creditors) will not wait to be paid.

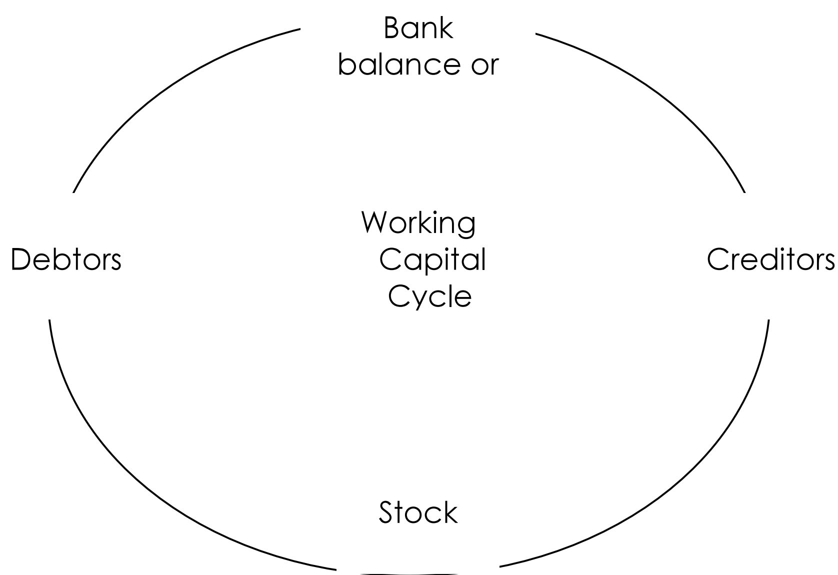
For a small business, it is shortage of ready cash to pay the bills today, which leads to failure even if the business is profitable. Cash is the short-term necessity while profit is needed in the medium to long term. It is important to focus on cash first, then profits and finally growth. In practice, too many owners of small businesses get this 100% the wrong way around. They focus on growth, then profits and finally cash, only to discover it is too late to save their business in the cash crisis that follows.

When thinking of the flow of cash into and out of your business there are three things you can control:

- Debtors – customers who owe you money
- Stock – materials, products in the process of being made and finished goods
- Creditors – suppliers and others you owe money to

Think of debtors as the main flow of cash into your business and creditors as the main flow out. Stock represents the stage in between and needs to be kept to a minimum, although you need to have your products available when customers want them. They are a temporary store of your cash, which you need to convert into sales as quickly as possible. There are other flows in and out, but these are the three you must control and use to your advantage. Together they form the working capital of your business.

Day to day, some of the 'cash' available to your business is spread out among creditors, stock and debtors so you cannot use it to pay bills. Together with any cash you have in the 'till' or at the bank, this is your working capital which flows around the working capital cycle below:



Your aim is to make sure that the right amount of cash is in the right place at the right time.

DEBTORS

There are a number of steps you should take in order to tighten up your debtor control and ease your cash situation.

- Take up credit references on all new customers. Credit agencies can supply summary details of their accounts and you can also approach their suppliers and bankers for their opinion.

- Make sure that customers know your standard terms and conditions of payment in writing. Confirm them again by sending an acknowledgement of their order and enclosing your terms and conditions of payment. This way they take precedence over your customers' terms and conditions.

- Make sure your invoices are accurate in every detail – errors give your customers excuses for delay.

- Make sure invoices are addressed to the correct person – ring and find out if necessary.

- Send out invoices as early as you can and wherever possible to arrive before the last day of the month end (so they can be processed straight away).

- Keep an up to date list of the credit that has been given to each customer using an aged debtor list. Make sure someone is responsible for ringing customers as soon as a payment is overdue. Once a regular customer knows you are monitoring late payment and that they can expect a telephone call, they will make sure you are paid on time. After all, who wants to have to 'fob off' suppliers with lame excuses?

- If a customer says the 'cheque is in the post' or gives a date which they will pay by, you must follow this up if you do not receive payment. Nobody likes to be exposed for breaking their promises.

- For customers who persistently pay late, you have to decide how much this is costing you and how important the customer is. No customer is worth it if they are going to put you out of business. You can:

  – Insist on cash payment before delivery
  – Give a small percentage discount for paying early (you can build this into your margin) or add a credit charge
  – Increase your price to meet the extra cost of late payment.
  – Decide not to do business
  – Keep the right to withdraw the goods in your contract if you can.

- For larger debts that are long overdue or in dispute, take legal advice. An initial consultation to see what chance of success you have may be free or there may be a fixed fee.

- If overdue debt is a persistent problem for your business, you could:

  – Employ a credit agency to chase payment on your behalf, or
  – Use an agency which 'factors' your debt. This gives you immediate payment of part of every invoice. (Your banker or local chamber of trade should be able to put you in touch with factoring agencies)

- You may be able to take out insurance against bad debts if it would seriously affect your survival.

Getting control of the amount your customers owe you takes time and effort which you could spend getting more business. But unless you have control of your debtors you might find you have no business at all.

STOCK CONTROL

The key to good stock control is to break down the totals for raw materials, work in progress and finished goods into individual product lines. Look at each one in turn and relate the stock value to how often it is used (raw materials) or to sales (finished goods). You can then identify:

- Redundant products which are not used or not being sold. You need to get rid of these in whatever way you can. Tell your Accountant so that he or she can consider writing these off in your accounts.

- Slow moving products, which are not used or sold often. Try a special clearance offer to boost sales and reduce stocks to a more realistic level.

- Fast moving products, which are used or sold quickly. Make sure you have enough stock to keep production going and to meet orders.

If your work in progress (WIP) is too high, you need to look at what is holding up your production process. Until you have turned raw materials into finished goods, you cannot sell or invoice for them, so your priority is to get them through your process and sold to customers.

In service and contracting businesses, your aim is to get your work to an agreed point at which you can invoice.

CREDITORS

Suppliers keep your business going by providing the goods (such as raw materials) and services (such as delivery service) that you need to do business with your customers. If your suppliers stop supplying you because you are not paying them on time, and no one else will supply you because you have poor credit references, then your business will grind to a halt. Creditors can even force your business to close if you do not pay what is due which means you need to be in control of your payments to creditors so that they continue to supply you.

Many businesses take the simplistic view that they should delay payment to creditors for as long as possible to get maximum benefit for themselves. This is especially true for large businesses, which have greater ‘clout’ with suppliers, especially if the supplier is a small business.

There is an alternative approach to doing business – you can treat suppliers as ‘partners’ who should not be squeezed as hard as you can get away with. For a small business, this approach is more likely to benefit you and your suppliers in the long run. For instance, suppliers will feel more inclined to help you out if your business has a problem with supply because they like doing business with you. Also, they are more likely to accept an occasional late payment if they know you have a short-term problem.

If you keep to the terms of payment, you maintain a good relationship, which can be of great benefit, when you really need the supplier’s help.

Keepmoat Plc operate under the Egan principles, supply chain management. This means they have agreements with key preferred suppliers which includes paying them promptly. Some of the suppliers are taking this partnership approach really to heart and providing business opportunities for Keepmoat with their customers. True partnership in practice.

STEP 5 Manage growth

Growth can refer to many different things: sales, product range, market share, size, number of employees, outlets and so on. Growth in all of these things can be good for the ego, but it may mean working harder for the same or less return.

Successful businesses focus on growth in profit. To make your business more profitable you do not have to grow in terms of sales, size, product range or any of the things listed above. In fact many businesses have improved profits by:

- Getting rid of unprofitable turnover (the big customer, who squeezes your margin, demands extra service and pays very late).

- Dropping products that lose money.

- Reducing size through cutting overheads, number of outlets and so on.

Before considering growth, go back to your breakeven sales analysis and focus on what you can do:

- Reduce your fixed costs

and

- Improve your gross profit percentage

You can improve your gross profit by:

- Getting better prices – increasing prices and dropping unprofitable customers and products

or

- Reducing material and employee costs.

Having set up a sound base for growth by controlling your gross profit and fixed costs, you should then consider the consequences of growth.

The real danger with growth is that it can happen too quickly and in an uncontrolled way. If a business grows like this, a number of things happen:

- The owner manager loses control of events through the sheer complexity and speed of change.

- The owner manager loses touch with customers and the people in the business.

- The business adds costs at least as quickly as it adds income – and so it becomes less profitable for more effort.

A huge amount of cash can be needed to fund growth:

- A manufacturing business will typically need between £200–£300 extra working capital for every additional £1,000 of sales.

- A service business, which carries little shock, will typically need between £120–£150 extra working capital for every additional £1,000 of sales.

- A retail business, which will have few debtors if any, will typically need between £80–£120 extra working capital for every additional £1,000 of sales.

If this extra cash is not available you end up with a cash flow crisis and even liquidation.

There have been many studies about the way successful small businesses grow. The main conclusion is that controlled step by step growth, with careful short term and long term planning, is the best way because:

- It allows owner managers to stay in control of events and in touch with customers and people as they change to a 'team managed' business.

- You keep control of your breakeven sales point and can make the most profit.

- You can predict how much cash you will need and arrange the funding in advance.

By looking at each of these in turn you can expand your business successfully.

How to stay in touch with customers and people

This is one of the big problems in a growing business, but as long as you realise this, you are at least half way to solving the problem.

As your business grows you will need to bring in other people to manage parts of it. Managing your business through others means you will have to learn new skills so you can delegate effectively, confidant that you remain in touch and in control. See toolkit 15 'Let go to grow'.

How to get maximum profits

By knowing your breakeven sales point month by month and projecting it into the future, you will be able to control how profitable you are. (See step 1).

Make sure your actual sales grow more quickly than your breakeven sales point. Many businesses that are growing find they add costs and reduce margins, which means the breakeven sales point rises quicker than sales.

How to predict funding needs

Growing faster than your funds allow you to is guaranteed to give you sleepless nights.

You must:

- Control your use of cash
- Predict and arrange funding for growth

You can predict the funding you will need for growth by working out the difference between what you need next year and what you will have available. The difference is your estimated funding requirement.

You can also use specially-developed computer software to try different 'what if' options (such as 'What if gross margin percentage is lower than I thought?' or 'What if more working capital is needed?'

For smaller businesses that may not have accountants in-house, simple worksheets enable you to keep your finger on the financial pulse of your business. Visit our website www.davidhalluk.com for details.