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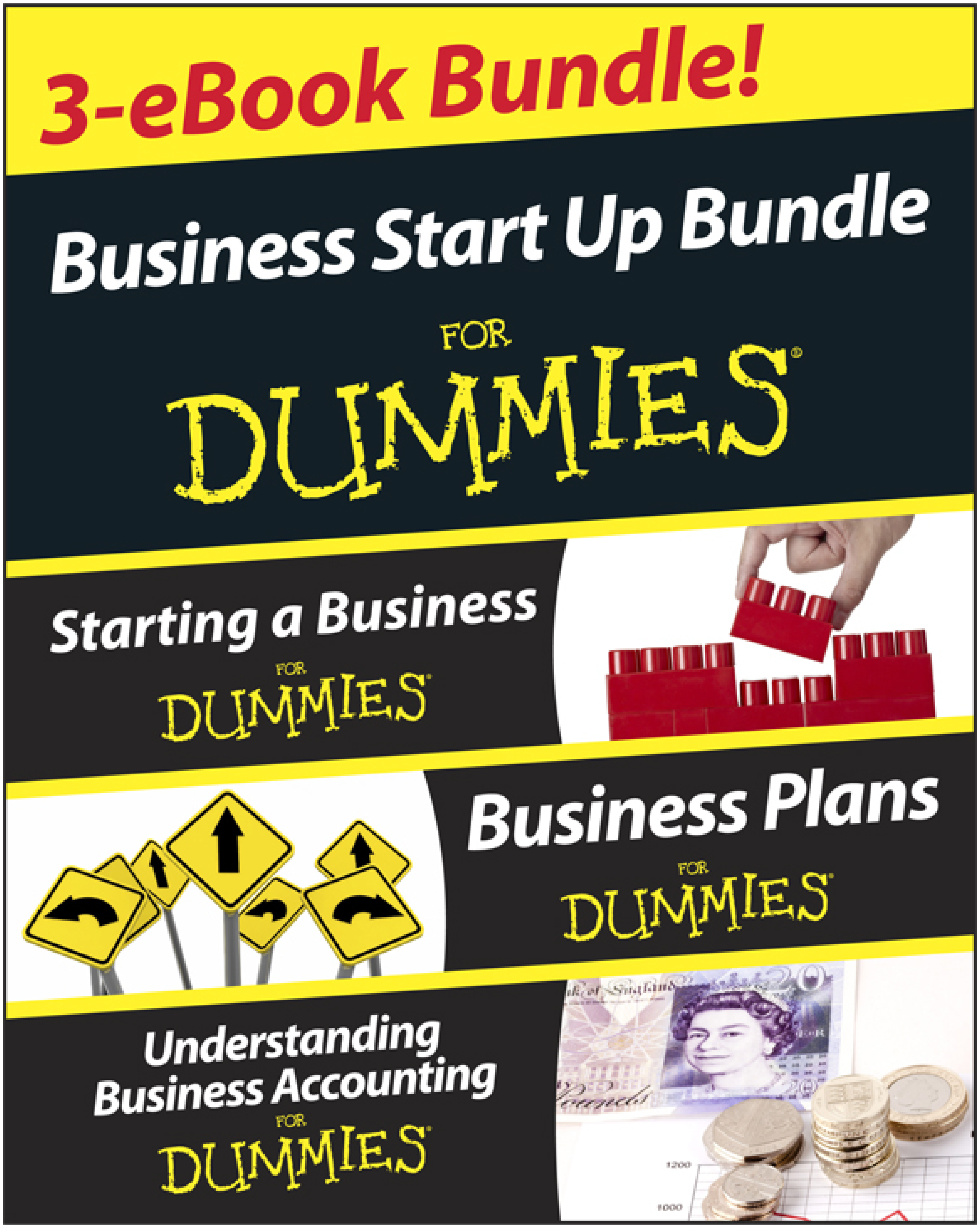

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Colin Barrow

Venture capitalist and entrepreneur

Starting a Business For Dummies®, 3rd Edition

by Colin Barrow

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About the Author

Colin Barrow was, until recently, Head of the Enterprise Group at Cranfield School of Management, where he taught entrepreneurship on the MBA and other programmes. He is also a visiting professor at business schools in the US, Asia, France, and Austria. His books on entrepreneurship and small business have been translated into twenty languages including Russian and Chinese. He worked with Microsoft to incorporate the business planning model used in his teaching programmes into the software program, Microsoft Business Planner. He is a regular contributor to newspapers, periodicals and academic journals such as the Financial Times, The Guardian, Management Today, and the International Small Business Journal.

Thousands of students have passed through Colin's start-up and business growth programmes, going on to run successful and thriving enterprises, and raising millions in new capital. He is on the board of several small businesses, is a University Academic Governor, and has served on the boards of public companies, venture capital funds, and on Government Task Forces.

Author's Acknowledgments

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We're proud of this book; please send us your comments through our Dummies online registration form located at www.dummies.com/register/.

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Starting a Business For Dummies®, 3rd Edition

Visit www.dummies.com/cheatsheet/startingabusinessuk to view this book's cheat sheet.

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Introduction

If you've pulled this book down from the shelf or had it passed to you by a friend or loved one as a gift, you don't have to be psychic to know something about your current business situation. You may be in need of this book for any number of reasons:

- You saw Lehman Brothers' staff queuing outside their offices with cardboard boxes and don't want that to happen to your business.
- A relative, hopefully a distant and elderly one, has died and left you a pile of dosh and you don't fancy leaving it to your stockbroker to lose on your behalf.
- Your employer is in the middle of a major downsizing operation as well as proposing to close its final salary pension scheme and relocate to somewhere with lousy schools and no healthcare facilities.
- You have a great idea for a world-beating product that no one has ever thought of but every one of the world's billion Internet users desperately needs – when they hear the good news they're going to click a path to your website.
- Your brother, sister, father, mother or best friend – or worse still, all of them – has started his or her own business and retired to a chateau in France to breed horses, tend the vines and sail on a luxury yacht.

If your present situation is founded largely on luck and serendipity, that isn't enough to get you through the business start-up process unaided. Good ideas, hard work, relevant skills and knowledge about your product and its market, though essential, on their own aren't enough. The 400,000 small firms that close their doors every year in the United Kingdom, a figure that rose sharply in the recent recession, are evidence enough that the process is a tough one.

This book is aimed at you if you either want to start up a business or to review your prospects in the small business world. It brings together, from a wide variety of sources, the essential elements of knowledge that are a prerequisite to understanding the world of small business and to achieving financial and personal success whatever the economic weather.

Why You Need This Book

Most business failures occur within the first 18 months of operation. That fact alone has made it increasingly clear that small businesses need special help, particularly in their formative period. The most crucial needs for owners and managers include:

- Help in acquiring business skills in such areas as basic bookkeeping and accounting. Most failing businesses simply don't know their financial position. Even if the order book is full, the cash can still run out.
- Knowledge of what sorts of finance are available and how to put themselves in the best possible position to raise money. Surprisingly, funds aren't in short supply. Problems lie, rather, in the business proposition itself or, more often, in the way in which the owner makes the proposition to the financier.
- Information with which to make realistic market assessments of the size and possibilities of their chosen market. Over-optimism about the size and ease with

which a market can be reached is an all too common mistake.

- Skills and tools to grow their businesses into valuable assets to pass on to family members or to sell up and sail off into the sunset.

This book gives you help in all these areas.

In addition, every business needs a *business plan*, a statement of business purpose, with the consequences of each element of that purpose spelt out in financial terms. You must describe what you want your business to do – who its potential customers are, how much they're likely to spend, who can supply you and how much their supplies cost. Then you must translate those plans and projections into cash – how much your business needs, how much you already have and how much you expect 'outsiders' to put in. This plan also helps you to avoid catching the 'common cold' of small businesses – underestimating the amount of start-up capital you need. Going back to a bank and asking for 30 per cent more funding six months after opening your doors, and retaining any credibility at all, is difficult if not impossible. And yet new businesses consistently underestimate how much money they need to finance their growth.

Many people have never prepared a business plan, they don't know how to start and they need new knowledge. That's where this book comes in. In these chapters, I give you the information you need to formulate and follow a business plan.

The book is also invaluable to innovators, who have special problems of communication and security when they try to translate their ideas into businesses. All too often their inventions are left for other countries to exploit, or they feel unhappy about discussing ideas, believing that a patent is their only protection. But more often than not, these business owners simply don't know who to talk to, little realising that sophisticated help is often close at hand. Thus this book illuminates a path from the laboratory to the marketplace so that small firms and inventors can see a clear route.

How to Use This Book

Starting a Business For Dummies can help you succeed no matter what kind of business expertise you're looking for. If you have a great and proven business idea, you may want to plug straight into finding out how to raise finance. If you need more than just yourself to get your great business idea off the ground, then you may want to discover how to find great employees or perhaps a business partner to take some of the financial and emotional strain. This book is set up so that you can dip in and out of it in a number of ways depending on your situation.

- If you haven't started a business before, or been profit accountable for part of an enterprise, then you may want to start at the beginning and work your way through.
- If you're more experienced, then you may start by selecting the areas you are less knowledgeable about to fill in the gaps and work outwards from there.
- If you're quite confident in the business world, you can use the book as a guide and mentor to review a particular topic. You can even use it to plan to sell your business after it's established and move on to a different challenge.
- If you learn by example, you may want to flip through the book, using the True Story icon as your guide. The text next to this icon highlights 'straight from the horse's mouth' examples of how successful entrepreneurs have

tackled specific situations, be it finding a partner, raising finance or getting a free grant from the government.

The next section tells you what the various parts of the book cover so that you can turn to a certain part for a specific need.

How This Book Is Organised

Starting a Business For Dummies is divided into five main parts based on the major elements involved in planning, launching and running a business. You don't have to read all the parts, however, and you certainly don't have to read them in order. Each chapter is devoted to a particular business start-up topic and you may need some chapters more than others. Feel free to jump from section to section and chapter to chapter; pick and choose what really matters to you and your business proposition.

Part I: Getting Started

Before you get a business off the ground you have to do all the preliminary legwork and make sure that you have a viable business on your hands before you commit too much time and money. This part gets you on track right away by helping you to gather crucial information on your marketplace, potential customers and competitors, and so test whether your idea is viable. It also provides a chance for you to check out your skills and attributes to help you establish the right business for you to start.

Part II: Making and Funding Your Plan

To ensure that your business prospers you have to know something about the legal structures under which you can trade and which suits you best at the outset. You need a business plan to help you both test the viability of your proposition and to share your ideas and aspirations with others, including potential investors, bankers or partners. You also want to review the financing options to make sure that you get both the right amount and type of finance for your business needs. You don’t have to do all this on your own, because the chapters in this part list key organisations that offer advice and help to business starters.

Part III: Staying in Business

After you get going you’ll almost certainly need to employ staff either full time, part time or on a temporary basis. This involves legal responsibilities that you should be prepared for. A business needs controlling in much the same way as a car or plane does. You need to understand what the key control documents are, and what they tell you about how your business is performing. You also need to have a sound appreciation of your income, expenses and tax liabilities, and how to minimise those liabilities legitimately.

Part IV: Making the Business Grow

After you have your business up and running you want to see how fast you can make it go without blowing a gasket or running off the road. Part of this process is a bit like fine-tuning a car engine. But part involves substantially changing everything, including the products and services, the markets you serve and perhaps even the very nature of your business operations. The process may even involve adopting a strategy to franchise your business idea, bolt a franchise onto your venture or form some other form of strategic alliance. This part covers the ins and outs of expanding your business safely and smartly.

Part V: The Part of Tens

The Part of Tens presents four chapters. One is a collection of warnings about the problems that most new businesses are likely to encounter and how to counteract them. Another contains details of the people you absolutely have to talk to before, during and after you've started up. The third chapter gives vital details on how to cut costs and so keep your business competitive. The final chapter provides pointers on maximising the value of your business, finding a buyer and then moving on to pastures new.

Icons Used in This Book

To help you pinpoint vital information, I've placed icons throughout the text to steer you to nuggets of knowledge.

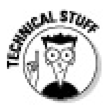
This icon calls your attention to particularly important points and offers useful advice on practical topics.

This icon serves as a friendly reminder that the topic at hand is important enough for you to make a note of.

Business, like any specialist subject, is awash with specialised terms and expressions, some of which may not be familiar to you. This icon draws your attention to these.

This icon alerts you that I'm using a practical example showing how another business starter has tackled a particular topic. Often you can apply the example to your own business.

This icon alerts you to a potential danger. Proceed with caution; look left and right before crossing. In fact, think carefully about crossing at all when you see this icon.



This icon refers to specialised business facts and data that are interesting as background data but not essential for you to know. You can skip paragraphs marked by this icon without missing the point – but reading them may help you build credibility with outside investors and partners.

Where to Go From Here

Take a minute to thumb through the table of contents and get comfortable with the topics the book covers. Pick a chapter that strikes a particular chord with the aspect of starting a business that's uppermost in your mind. Read that and see where it leads you.

You can also use Chapter 6, 'Preparing the Business Plan', as a framework for gathering knowledge and diving back into the other chapters as you go.

If all else fails, start at the beginning. That technique has a pretty good track record.

Part I
Getting Started

'OK – here's the business plan. Nigel takes charge of marketing, Tristram sales, Keith accounts, and Psycho makes sure clients pay on time.'

In this part . . .

Before you can think seriously about starting your own business, you need to make sure you are ready for such a big step. This part lets you check out your skills and aptitude and see how they compare to the business idea you have in mind.

You can see if your idea looks able to make the kind of money you're expecting. Then check if you should start up on your own or perhaps find others to help you.

Once you've done the groundwork you can start investigating the market in more detail and lay the groundwork for opening your doors for business either at home or in dedicated premises. With this work done you are ready to take your business forward!

Chapter 1

Preparing for Business

In This Chapter

- Getting to grips with the basics of business strategy
- Working up to opening up
- Measuring your business's viability
- Growing for success

When you're starting a business, particularly your first business, you need to carry out the same level of preparation as you would for crossing the Gobi Desert or exploring the jungles of South America. You're entering hostile territory.

Your business idea may be good, it may even be great, but such ideas are two a penny. The patent office is stuffed full of great inventions that have never returned tuppence to the inventors who spent so much time and money filing them. It's how you plan, how you prepare and how you implement your plan that makes the difference between success and failure. And failure is pretty much a norm for business start-ups. Tens of thousands of small firms fail, some disastrously, every year. Most are perfectly ordinary enterprises – catastrophe isn't confined to brash Internet whiz kids entering markets a decade or so ahead of the game.

This chapter sets the scene to make sure that you're well prepared for the journey ahead.

Understanding the Enduring Rules of Business Strategy

When you're engulfed by enthusiasm for an idea for a new business or engaged in the challenge of getting it off the ground you can easily miss out on the knowledge you can gain by lifting your eyes up and taking the big picture on board too. There isn't much point in taking aim at the wrong target from the outset!

Credit for devising the most succinct and usable way to get a handle on the big picture has to be given to Michael E. Porter, who trained as an economist at Princeton, taking his MBA at Harvard Business School where he's now a professor. Porter's research led him to conclude that two factors above all influence a business's chances of making superior profits – surely an absolute must if you're going to all the pain of working for yourself.

- **The attractiveness or otherwise of the industry in which it primarily operates.** That's down to your research, a subject I cover in Chapters 2 and 4.
- **How the business positions itself within the industry in terms of an organisation's sphere of influence.** In that respect a business can only have a cost advantage if it can make products or deliver services for less than others. Or the business may be different in a way that matters to consumers, so that its offers are unique, or at least relatively so.

Porter added a further twist to his prescription. Businesses can follow either a cost advantage path or a differentiation path industry wide, or they can take a third path – they can concentrate on a narrow specific segment either with cost advantage or differentiation. This he termed *focus strategy*, which I discuss in the following sections.

Focus, focus, focus

Whoa up a minute. Before you can get a handle on focus you need to understand exactly what the good professor means by *cost leadership* and *differentiation*, because the combination of those provides the most fruitful arena for a new business to compete.

Cost leadership

Don't confuse low cost with low price. A business with low costs may or may not pass those savings on to customers. Alternatively, the business could use low costs alongside tight cost controls and low margins to create an effective barrier to others considering either entering or extending their penetration of that market.

Businesses are most likely to achieve low cost strategies in large markets, requiring large-scale capital investment, where production or service volumes are high and businesses can achieve economies of scale from long runs. If you have deep pockets, or can put together a proposition that convinces the money men to stump up the cash, this could be an avenue to pursue. (I cover everything you need to put together a great business plan in Chapter 6.)

Ryanair and easyJet are examples of fairly recent business start-ups where analysing every component of the business made it possible to strip out major elements of cost – meals, free baggage and allocated seating, for example – while leaving the essential proposition – we will fly you from A to B – intact.

Enough of a strategy to give bigger, more established rivals such as British Airways a few sleepless nights.

Differentiation

The key to *differentiation* (making sure your product or service has a unique element that makes it stand out from the rest) is a deep understanding of what customers really want and need and more importantly what they're prepared to pay more for. Apple's opening strategy was based around a 'fun' operating system based on icons, rather than the dull MS-DOS. This belief was based on Apple's understanding that computer users were mostly young and wanted an intuitive command system and the 'graphical user interface' delivered just that. Apple has continued its differentiation strategy, but added design and fashion to ease of control to the ways in which it delivers extra value. Sony and BMW and are also examples of differentiators. Both have distinctive and desirable differences in their products and neither they nor Apple offer the lowest price in their respective industries; customers are willing to pay extra for the idiosyncratic and prized differences embedded in their products.

Consumers can be a pretty fickle bunch. Just dangle something faster, brighter or just plain newer and you can usually grab their attention. Your difference doesn't have to be profound or even high-tech to capture a slice of the market. Book buyers rushed in droves to Waterstone's for no more profound a reason than that its doors remained open in the evenings and on Sundays, when most other established bookshops were firmly closed.

Focus

Your patience is about to be rewarded. Now I can get to the strategy that Porter reckoned was the most fruitful for new business starters to plunge into.

Focused strategy involves concentrating on serving a particular market or a defined geographic region. IKEA, for example, targets young, white collar workers as its prime customer segment, selling through 235 stores in more than 30 countries. Ingvar Kamprad, an entrepreneur from the Småland province in southern Sweden, who founded the business in the late 1940s, offers home furnishing products of good function and design at prices young people can afford. He achieves this by using simple cost-cutting solutions that don't affect the quality of products. (You can read more about Kamprad in the nearby sidebar 'Less is more'.)

Warren Buffett, the world's richest man, knows a thing or two about focus. His investment company combined with Mars to buy US chewing gum manufacturer Wrigley for $23 billion (£11.6 billion) in May 2008. Chicago-based Wrigley, which launched its Spearmint and Juicy Fruit gums in the 1890s, has specialised in chewing gum ever since and consistently outperformed its more diversified competitors. Wrigley is the only major consumer products company to grow comfortably faster than the population in its markets and above the rate of inflation. Over the past decade or so, for example, other consumer products companies have diversified. Gillette moved into batteries used to drive many of its products by acquiring Duracell. Nestlé bought Ralston Purina, Dreyer's, Ice Cream Partners and Chef America. Both have trailed Wrigley's performance.

Businesses often lose their focus over time and periodically have to rediscover their core strategic purpose. Procter & Gamble is an example of a business that had to refocus to cure weak growth. In 2000 the company was losing share in seven of its top nine categories, and had lowered earnings expectations four times in two quarters. This prompted the company to restructure and refocus on its core business: big brands, big customers and big countries. Procter & Gamble sold off non-core businesses, establishing five global business units with a closely focused product portfolio.

Appreciating the forces at work in your sector

Aside from articulating the generic approach to business strategy, Porter's other major contribution to the field was what has become known as the Five Forces Theory of Industry Structure. Porter postulated that you have to understand the five forces that drive competition in an industry as part of process of choosing which of the three generic strategies (cost leadership, differentiation or focus) to pursue. The forces he identified are:

- **Threat of substitution:** Can customers buy something else instead of your product? For example, Apple and to a lesser extent Sony have laptop computers that are distinctive enough to make substitution difficult. Dell, on the other hand, faces intense competition from dozens of other suppliers with near identical products competing mostly on price alone.
- **Threat of new entrants:** If it's easy to enter your market, start-up costs are low and no barriers to entry, such as intellectual property protection, exist then the threat is high.
- **Supplier power:** Usually, the fewer the suppliers, the more powerful they are. Oil is a classic example where less than a dozen countries supply the whole market and consequently can set prices.

- **Buyer power:** In the food market, for example, just a few, powerful supermarket buyers are supplied by thousands of much smaller businesses, so the buyers are often able to dictate terms.
- **Industry competition:** The number and capability of competitors is one determinant of a business's power. Few competitors with relatively less attractive products or services lower the intensity of rivalry in a sector. Often these sectors slip into *oligopolistic behaviour*, preferring to collude rather than compete You can see a video clip of Professor Porter discussing the five force model on the Harvard Business School website (http://hbr.org/2008/01/the-five-competitive-forces-that-shape-strategy/ar/1).

Recognising the first-to-market fallacy

People use the words 'first mover advantage' like a mantra to justify a headlong rush into starting a business without doing enough basic research. That won't happen to you – after all, you're reading this book and by the end of this section you'll be glad you paused for thought.

The idea that you have the best chance of being successful if you get in first is one of the most enduring in business theory and practice. Entrepreneurs and established giants are always in a race to be first. Research from the 1980s claimed to show that market pioneers have enduring advantages in distribution, product-line breadth, product quality and, especially, market share.

Less is more

Furniture company IKEA was founded by Ingvar Kamprad when he was just 17, having cut his teeth on selling matches to his nearby neighbours at the age of 5, followed by spells selling flower seeds, greeting cards, Christmas decorations and eventually furniture. Worth £16 billion, Kamprad is the world's seventh richest man, but lives frugally, in keeping with the functional nature of the IKEA brand. He lives in a bungalow, flies easyJet and drives an 18-year-old Volvo. When he arrived at a gala dinner recently to collect a business award, the security guard turned him away because he saw Kamprad getting off a bus. He and his wife Margaretha are often seen dining in cheap restaurants. He does his food shopping in the afternoon when prices are lower and even then haggles prices down.

Beguiling though the theory of first mover advantage is, it's probably wrong. Gerard Tellis, of the University of Southern California, and Peter Golder, of New York University's Stern Business School, argue in their research that previous studies on the subject were deeply flawed. In the first instance earlier studies were based on surveys of surviving companies and brands, excluding all the pioneers that failed. This helps some companies to look as though they were first to market even when they weren't. Procter & Gamble boasts that it created America's disposable-nappy (diaper) business. In fact a company called Chux launched its product a quarter of a century before Procter & Gamble entered the market in 1961.

Also, the questions used to gather much of the data in earlier research were at best ambiguous and perhaps dangerously so. For example, researchers had used the term 'one of the pioneers in first developing such products or services' as a proxy for 'first to market'. The authors emphasise their point by listing popular misconceptions of who the real pioneers were across the 66 markets they analysed:

- **Online book sales:** Amazon (wrong); Books.com (right).
- **Copiers:** Xerox (wrong); IBM (right).
- **PCs:** IBM/Apple (both wrong); Micro Instrumentation Telemetry Systems (right) – it introduced its PC, the Altair, a $400 kit, in 1974 followed by Tandy Corporation (Radio Shack) in 1977.

In fact the most compelling evidence from all the research is that nearly half of all firms pursuing a first to market strategy are fated to fail, but those following fairly close behind are three times as likely to succeed. Tellis and Golder claim the best strategy is to enter the market a few years after pioneers, learn from their mistakes, benefit from their product and market development and be more certain about customer preferences.

Getting in Shape to Start Up

You need to be in great shape to start a business. You don't have to diet or exercise, at least not in the conventional sense of those words, but you do have to be sure that you have the skills and knowledge you need for the business you have in mind, or know how to tap into sources of such expertise.

The following sections help you through a pre-opening check-up so that you can be absolutely certain that your abilities and interests are closely aligned to those that the business you have in mind requires. The sections also help you to check that a profitable market exists for your products or services. You can use these sections as a vehicle for sifting through your business ideas to see whether they're worth the devotion of time and energy that you need to start up a business.

You may well not have all the expertise you need to do everything yourself. Chapter 7 introduces you to the zillions of agencies and advisers who can fill in the gaps in your expertise.

Assessing your abilities

Business lore claims that for every ten people who want to start their own business, only one finally does. It follows that an awful lot of dreamers exist who, while liking the idea of starting their own business, never get around to taking action. Chapter 3 looks in detail at how you can assess whether you're a dreamer or a doer when it comes to entrepreneurship. For now, see whether you fit into one of the following entrepreneurial categories:

- **Nature:** If one of your parents or siblings runs their own business, successfully or otherwise, you're highly likely to start up your own business. No big surprise here, as the rules and experiences of business are being discussed every day and some of it's bound to rub off. It also helps if you're a risk taker who's comfortable with uncertainty.
- **Nurture:** For every entrepreneur whose parents or siblings have a business there are two who don't. If you can find a business idea that excites you and has the prospect of providing personal satisfaction and wealth, then you can assemble all the skills and resources needed to succeed in your own business. You need to acquire good planning and organisational skills (Chapter 6 covers all aspects of writing a business plan) and either develop a well-rounded knowledge of basic finance, people management, operational systems,

business law, marketing and selling, or get help and advice from people who have that knowledge.

- **Risk taker:** If you crave certainty in everything you do, then running your own business may be something of a culture shock. By the time the demand for a product or service is an absolutely sure-fire thing, there may already be too many other businesses in the market to leave much room for you. Don't confuse risk taking with a pure gamble. You need to be able to weigh matters up and make your risk a calculated one.
- **Jack-of-all-trades:** You need to be prepared to do any business task at any time. The buck definitely stops with you when you run your own business. You can't tell a customer that his delivery is late just because a driver fails to show up. You just have to put in a few more hours and do the job yourself.

Discovering a real need

You may be a great potential entrepreneur, but you still need to spell out exactly what it is you plan to do, who needs it and how it can make money. A good starting point is to look around and see whether anyone is dissatisfied with their present suppliers. Unhappy customers are fertile ground for new businesses to work in.

One dissatisfied customer isn't enough to start a business for. Make sure that unhappiness is reasonably widespread, because that gives you a feel for how many customers may be prepared to defect. After you have an idea of the size of the potential market, you can quickly see whether your business idea is a money-making proposition.

Aside from asking around, one way to get a handle on dissatisfaction levels is to check out websites that allow consumers to register their feelings, such as www.complaints.com, www.grumbletext.co.uk and www.blagger.com. Then scour blogs (short for weblogs), where irate people can complain their hearts out. Check out websites such as www.technorati.com, www.totalblogdirectory.com and www.bloghub.com, which all operate blog-indexing services that can help you filter through the 70 million plus blogs and reach the few dozen that serve the sector you're interested in.

The easiest way to fill a need that people are going to pay to have satisfied is to tap into one or more of these triggers:

- **Cost reduction and economy:** Anything that saves customers money is always an attractive proposition. Lastminute.com's appeal is that it acts as a 'warehouse' for unsold hotel rooms and airline tickets that you can have at a heavy discount.
- **Fear and security:** Products that protect customers from any danger, however obscure, are enduringly appealing. When Long-Term Capital Management (LTCM), one of America's largest hedge funds, collapsed and had to be rescued by the Federal Reserve at a cost of $2 billion, it nearly brought down the American financial system single-handedly. Two months later Ian and Susan Jenkins launched the first issue of their magazine, *EuroHedge*. At the time 35 hedge funds existed in Europe, but investors knew little about them and were rightly fearful for their investments. *EuroHedge* provided information and protection to a nervous market and five years after its launch the Jenkinses sold the magazine for £16.5 million.

- **Greed:** Anything that offers the prospect of making exceptional returns is always a winner. *Competitors' Companion*, a magazine aimed at helping anyone become a regular competition winner, was an immediate success. The proposition was simple: subscribe and you get your money back if you don't win a competition prize worth at least your subscription. The magazine provided details of every competition being run that week, details of how to enter, the factual answers to all the questions and pointers on how to answer any tie breakers. It also provided the inspiration to ensure success with this sentence: you have to enter competitions in order to have a chance of winning them.
- **Niche markets:** Big markets are usually the habitat of big business – encroach on their territory at your peril. New businesses thrive in markets that are too small even to be an appetite whetter to established firms. These market niches are often easy prey to new entrants because businesses have usually neglected, ignored or served them badly in the past.

Checking the fit of the business

Having a great business idea and possessing the attributes and skills you require to start your own business successfully are two vital elements to get right before you launch. The final ingredient is to be sure that the business you plan to start is right for you.

Before you go too far, make an inventory of the key things that you're looking for in a business. These may include working hours that suit your lifestyle; the opportunity to meet new people; minimal paperwork; a chance to travel. Then match those up with the proposition you're considering. (Chapter 3 talks more about finding a good business fit.)

Confirming Viability

An idea, however exciting, unique, revolutionary and necessary, isn't a business. It's a great starting point, and an essential one, but you have to do a good deal more work before you can sidle up to your boss and tell him exactly what you think of him.

The following sections explore the steps you need to take so that you don't have to go back to your boss in six months and plead for your old job back (and possibly eat a large piece of humble pie at the same time).

Researching the market

However passionate you are about your business idea, you're unlikely already to have the answers to all the important questions concerning your marketplace. Before you can develop a successful business strategy, you have to understand as much as possible about your market and the competitors you're likely to face.

Inflated numbers on the Internet

If you plan to advertise on an Internet site it makes sense to check out the different sites you're considering. Be aware that some sites publish a fair amount of gobbledygook about the high number of 'hits' (often millions) they receive. Millions of hits don't mean that the site has millions of visitors. Some Internet sites increase their hit rate by the simple expedient of leading each viewer through a number of pages, each of which adds to the number of hits. Another mildly meaningless measure of the advertising value of a site is the notion of a *subscriber*. In Internet parlance anyone visiting a website and giving over their email address becomes part of that company's share price! Compare that to the suggestion that anyone passing a shop and glancing in the window turns into hard cash the following day.

Any real analysis of website use starts with *page impression*, which is a measure of how many times an individual page has been viewed. The Audit Bureau of Circulations, which started its life measuring newspaper response, has now turned its attention to auditing websites (www.abc.org.uk). Also check out the World Internet Usage website (www.internetworldstats.com/stats.htm) for the latest statistics on Internet penetration by continent and country. That gives you a realistic measure of the maximum traffic and relative importance of each market you're interested in.

The main way to get to understand new business areas, or areas that are new to you at any rate, is to conduct market research. The purpose of that research is to ensure that you have sufficient information on customers, competitors and markets so that your market entry strategy or expansion plan is at least on target, if not on the bull's-eye itself. In other words, you need to explore whether enough people are attracted to buy what you want to sell at a price that gives you a viable business. If you miss the target altogether, which you may well do without research, you may not have the necessary resources for a second shot.

The areas to research include:

- **Your customers:** Who may buy more of your existing goods and services and who may buy your new goods and services? How many such customers exist? What particular customer needs do you meet?

- **Your competitors:** Who are you competing with in your product/market areas? What are those firms' strengths and weaknesses?
- **Your product or service:** How can you tailor your product or service to meet customer needs and give you an edge in the market?
- **The price:** What do customers see as giving value for money, so encouraging both loyalty and referral?
- **The advertising and promotional material:** What newspapers, journals and so forth do your potential customers read and what websites do they visit? Unglamorous as it is, analysing data on what messages actually influence people to buy, rather than just to click, holds the key to identifying where and how to promote your products and service.
- **Channels of distribution:** How can you get to your customers and who do you need to distribute your products or services? You may need to use retailers, wholesalers, mail order or the Internet. These methods all have different costs and if you use one or more, each wants a slice of your margin.
- **Your location:** Where do you need to be to reach your customers most easily at minimum cost? Sometimes you don't actually need to be anywhere near your market, particularly if you anticipate most of your sales coming from the Internet. If this is the case you need to have a strategy to make sure that potential customers can find your website.

Try to spend your advertising money wisely. Nationwide advertisements or blanketing the market with free CD-ROMs may create huge short-term growth, but little evidence exists that indiscriminate blunderbuss advertising works well in retaining customers. Certainly, few people using such techniques make any money.

Doing the numbers

Your big idea looks as though it has a market. You've evaluated your skills and inclinations and you believe that you can run this business. The next crucial question is – can it make you money?

You absolutely must establish the financial viability of your idea before you invest money in it or approach outsiders for backing. You need to carry out a thorough appraisal of the business's financial requirements. If the numbers come out as unworkable, you can then rethink your business proposition without losing anything. If the figures look good, then you can go ahead and prepare cash flow projections, a profit and loss account and a balance sheet, and put together the all-important business plan. (Chapters 6 and 13 cover these procedures.)

You need to establish for your business:

- Day-to-day operating costs
- How long it will take to reach break-even
- How much start-up capital you need
- The likely sales volume

- The profit level you require for the business not just to survive, but also to thrive
- The selling price of your product or service

Many businesses have difficulty raising start-up capital. To compound this, one of the main reasons small businesses fail in the early stages is that they use too much start-up capital to buy fixed assets. Although some equipment is clearly essential at the start, you can postpone other purchases. You may be better off borrowing or hiring ‘desirable’ and labour-saving devices for a specific period. This obviously isn’t as nice as having them to hand all the time, but remember that you have to maintain and perhaps update every photocopier, printer, computer and delivery van you buy and they become part of your fixed costs. The higher your fixed costs, the longer it usually takes to reach break-even point and profitability. And time isn’t usually on the side of the small, new business: it has to become profitable relatively quickly or it simply runs out of money and dies.

Raising the money

Two fundamentally different types of money that a business can tap into are debt and equity.

- JARGON ALERT **Debt** is money borrowed, usually from a bank, and that you have to repay. While you’re making use of borrowed money you also have to pay interest on the loan.
- **Equity** is the money that shareholders, including the proprietor, put in and money left in the business by way of retained profit. You don’t have to give the shareholders their money back, but shareholders do

expect the directors to increase the value of their shares, and if you go public they'll probably expect a stream of dividends too.

If you don't meet the shareholders' expectations, they won't be there when you need more money – or, if they're powerful enough, they'll take steps to change the membership of the board.

Alternative financing methods include raising money from family and friends, applying for grants and awards, and entering business competitions. Check out Chapter 8 for a review of all these sources of financing.

The Financial Services Authority, a City watchdog, ordered all banks to publish statistics on complaints on their website from 31 August 2010. Lloyds had received 288,717 complaints in the first six months of the year, Santander 244,978, Barclays 195,956 and HSBC had just 65,236. If your bank is high on this name and shame list get straight on to Chapter 8 where I cover all aspects of raising money.

Writing up the business plan

A *business plan* is a selling document that conveys the excitement and promise of your business to potential backers and stakeholders. These potential backers can include bankers, venture capital firms, family, friends and others who may help you launch your business if they only know what you want to do. (Chapter 8 considers how to find and approach sources of finance.)

Getting money is expensive, time consuming and hard work. Having said that, you can get a quick decision. One recent start-up succeeded in raising £3 million in eight days, after the founder turned down an earlier offer of £1 million made just 40 minutes after he presented his business plan. Your business plan should cover what you expect to achieve over the next three years. (Chapter 6 gives full details on how to write a winning business plan.)

Most business plans are dull, badly written and frequently read only by the most junior of people in the financing organisations they're presented to. One venture capital firm in the United States went on record to say that in one year it received 25,000 business plans asking for finance and invested in only 40. Follow these tips to make your business plan stand out from the crowd:

- **Hit them with the benefits:** You need to spell out exactly what you do, for whom and why that matters. One such statement that has the ring of practical authority is: 'Our website makes ordering gardening products simple. It saves the average customer two hours a week browsing catalogues and £250 a year through discounts not otherwise available from garden centres. We have surveyed 200 home gardeners, who rate efficient purchasing as a key priority.'
- **Make your projections believable.** Sales projections always look like a hockey stick – a straight line curving rapidly upwards towards the end. You have to explain exactly what drives growth, how you capture sales and what the link between activity and results is. The profit margins are key numbers in your projections, alongside sales forecasts. Financiers tend to probe these figures in depth, so show the build-up in detail.

- **Say how big the market is.** Financiers feel safer backing people in big markets. Capturing a fraction of a percentage of a massive market may be hard to achieve – but if you get it at least the effort is worth it. Going for 10 per cent of a market measured in millions rather than billions may come to the same number, but the result isn't as interesting.
- **Introduce yourself and your team.** You need to sound like winners with a track record of great accomplishments.
- **Include non-executive directors.** Sometimes a heavyweight outsider can lend extra credibility to a business proposition. If you know or have access to someone with a successful track record in your area of business who has time on his hands, you can invite him to help. If you plan to trade as a limited company (Chapter 5 has details on legal structures) you can ask him to be a director, without specific executive responsibilities beyond being on hand to offer advice. But non-executive directors do need to have relevant experience or be able to open doors and do deals. Check out organisations such as Venture Investment Partners (www.ventureip.co.uk) and First Flight Placement's non-exec search site (www.nonexecutivedirector.co.uk) for information on tracking down the right non-executive director for your business.
- **Provide financial forecasts.** You need projected cash flows, profit and loss accounts and balance sheets for at least three years ahead. No one believes them after Year 1, but the thinking behind them is what's important.
- **Demonstrate the product or service.** Financiers need to see what the customer is going to get. A mock-up is okay or, failing that, a picture or diagram. For a service, show

how customers can gain from using it – that it can help with improved production scheduling and so reduce stock holding, for example.

- **Spell out the benefits to your potential investors.** Tell them that you can repay their money within *x* years, even on your most cautious projections. Or if you're speaking to an equity investor, tell him what return he may get on his investment when you sell the business in three or five years' time.

Going for Growth

Growth is as natural a feature of business life as it is of biological life. People, animals and plants all grow to a set size range and then stop. A few very small and very large specimens come to fruition, but the vast majority fit within a fairly narrow size band.

Businesses follow a similar formula: most successful new businesses, those that survive that is, reach a plateau within five to seven years. At that stage the business employs 5 to 20 people and has annual sales of between £250,000 and £1 million. Of the 4.4 million private businesses operating in the United Kingdom, fewer than 120,000 have a turnover in excess of £1 million a year. That doesn't represent a bad result. Viewed from the position of a one-man-band start-up, having a couple of hundred thousand pounds in sales each year is an admirable (and unusual) success.

The following sections demonstrate the great benefits of growth (Chapters 15, 16, 17 and 18 contain more advice on how to make your business grow).

Gaining economies of scale

After a business starts to grow, you can spread overhead costs over a wider base. You can buy materials and services in larger quantities, which usually means better terms and lower costs. The combination of these factors generally leads to a higher profit margin, which in turn provides funds to improve the business, which in turn can lead to even lower costs. This *virtuous circle* can make a growing firm more cost competitive than one that's cautiously marking time.

Securing a competitive advantage

A new business can steal a march on its competitors by doing something vital that established businesses can't easily imitate. For example, a new hairdressing shop can locate where customers are, but an existing shop has to content itself with its current location, at least until its lease expires.

A growing firm can gain advantages over its slower competitors. For example, launching new products or services gives a firm more goods to sell to its existing customer base. This puts smaller competitors at a disadvantage, because they're perceived as having less to offer than the existing supplier. This type of growth strategy can, if coupled with high quality standards, lead to improved customer retention and this too can lead to higher profits – a further push on the momentum of the virtuous circle.

Retaining key staff

The surest way to ensure that a business fails is to have a continual churn of employees coming and going. You have to invest valuable time and money in every new employee before he becomes productive, so the more staff you lose the more growth you sacrifice. Most employers believe that their staff work for money and their key staff work for more money. The facts don't really support this hypothesis. All the evidence is that employees want to have an interesting job and recognition and praise for their achievements. In Chapter 18 you can find out how to get the best out of your staff.

By growing the business you can let key managers realise their potential. In a bigger business you can train and promote your staff, moving them up the ladder into more challenging jobs, earning higher salaries on merit, while they stay with you rather than leaving for pastures new. And if employees are good at their jobs, the longer they stay with you, the more valuable they become. You save time and money on recruitment and you don't have to finance new managers' mistakes while they learn how to work in your business.

Gaining critical business mass

Bigger isn't always better, but a growing business has a greater presence in its market, and that's rarely a bad strategy. Large businesses are also more stable, tending to survive better in turbulent times. Bigger businesses can and do sometimes go bust, but smaller, 'doing nicely' businesses are far more likely to go bump.

A small company often relies on a handful of customers and just one or two products or services for most or all of its profits. If its main product or service comes under competitive pressure, or if a principal customer goes bust, changes supplier, or spreads orders around more thinly, then the small company is in trouble. Expanding the number of customers so that you break out of the 80/20 cycle – in which 80 per cent of the business comes from just 20 per cent of customers – is a sensible way to make your business safer and more predictable.

One-product businesses are the natural medium of the inventor, but they're extremely vulnerable to competition, changes in fashion and technological obsolescence. Having only one product can limit the growth potential of the enterprise. A question mark must inevitably hang over such ventures until they can broaden their product base. Adding successful new products or services helps a business to grow and become a safer and more secure venture. This process is much like buying a unit trust rather than investing in a couple of shares. The individual shares are inevitably more volatile, but the spread over dozens of shares smoothes the growth path and reduces the chances of disaster significantly.

Chapter 2

Doing the Groundwork

In This Chapter

- Understanding what a small business is
- Checking whether you're the business type
- Running towards great ideas and avoiding bad ones
- Appreciating the impact of the broader economy
- Recognising success characteristics

If you've worked in a big organisation, you know that a small and medium enterprise (SME) is a very different kind of animal from a big business. SMEs are more vulnerable to the vagaries of the economy, but are vital to its vigour.

In this chapter you can find out how to come up with a great business idea and avoid the lemons. You can also look at the most common mistakes that businesses starting up make and how you can avoid them.

Understanding the Small Business Environment

During one of the all too many periods in recent history when the business climate was particularly frigid, the recent global credit crunch being a good example, some bright spark claimed that the only sure-fire way to get a small business safely down the slipway was to start out with a big one and shrink it down to size. There's no denying that's one way to get started, but even as a joke the statement completely misses the point. Small businesses have almost nothing in common with big ones. Just because someone, you perhaps, has worked in a big business, however successfully, that's no guarantee of success in the small business world.

Big businesses usually have deep pockets and even if those pockets aren't actually stuffed full of cash, after years of trading under their belt they can in all but the most extraordinary of circumstances get the ear of their bank manager. Even if unsuccessful at the bank big firms can generally extract credit from suppliers, especially if the suppliers are smaller and susceptible to being lent on in order to retain them as a customer. If all else fails big businesses may have the option to tap their shareholders or go out to the stock market for more boodle – options a small business owner can only dream about. And of course if the business is very big, in times of extreme hardship it can expect a sympathetic hearing from the government. The UK Government shrank from letting Northern Rock fold, the US Government threw General Motors a lifeline and France's Nicholas Sarkozy used public cash to keep Renault and Peugeot Citroën in business so long as they kept their French factories open. The boss of a big firm has legions of staff to carry out research, or to do all those hundred and one boring but essential jobs like writing up the books, essential preludes to tapping into credit.

In contrast, small business founders have to stay up late burning the midnight oil, poring over those figures themselves. To cap it all, they may even have to get up at dawn and make special deliveries to customers in order to ensure that they meet deadlines. Big business bosses have chauffeurs and travel business class; after all, they don't own a large proportion of the business's shares, so however frugal they are they won't be much richer. Small firm founders, in contrast, are personally poorer every time an employee makes a phone call at work, books a business trip or takes a client out to lunch, unless that call, trip or lunch generates extra business. The question that separates owners from employees – which is, after all, what bosses of big businesses really are, however powerful they look from below – is: if it was your money would you spend it on that call, business trip or lunch? Seven times out of ten the answer is no way, not with my dosh.

Defining Small Business

Small business defies easy definition. Typically, people apply the term *small business* to one-man bands such as shops, garages and restaurants, and apply the term *big business* to such giants as IBM, General Motors, Shell and Microsoft. But between these two extremes fall businesses that you may looked upon as big or small, depending on the yardstick and cut-off point you use to measure size.

No single definition exists of a small firm, mainly because of the wide diversity of businesses. One wit claimed that a business was small if it felt it was, and a grain of truth exists in that point of view.

In practical terms the only reason to be concerned about a business's size, age or business sector is the support and constraints imposed by virtue of those factors. The government, for example, may offer grant aid, support or even constraints based on such factors. For instance, a business with a very small annual sales turnover, less than £15,000, can file a much simpler set of accounts than a larger business can.

Looking at the Types of People Who Start Businesses

At one level statistics on small firms are very precise. Government collects and analyses the basic data on how many businesses start (and close) in each geographic area and what type of activity those businesses undertake. Periodic studies give further insights into how new and small firms are financed or how much of their business comes from overseas markets. Beyond that the 'facts' become a little more hazy and information comes most often from informal studies by banks, academics and others who may have a particular axe to grind.

The first fact about the UK small business sector is how big it is. Over 4.7 million people now run their own business, up from 1.9 million some three decades ago.

The desire to start a business isn't evenly distributed across the population as a whole. Certain factors such as geographic area and age group seem to influence the number of start-ups at any one time. The following sections explore some of these factors.

Making your age an asset

Research by the Global Entrepreneurship Monitor (www.gemconsortium.org) and the UK Office for National Statistics (www.statistics.gov.uk) reveals a number of interesting facts about small business starters. First, people aged between 25 and 44 are more likely than those in other age groups to be planning to start a business. Over 5 per cent of people in the 25–44 age group are starting a business on their own or with others. Around 3 per cent of those under 24 or between 45 and 54 also have business start-up plans. Those over 55 are the least likely to want to start up, with only 1.5 per cent heading for self-employment.

But those percentages are only showing those planning a start-up. Around three times those proportions are already running small or medium-sized businesses.

Considering location

More than three times as many people in London start a business as do those in the North East of England. At the very least you're more likely to feel lonelier as an entrepreneur in that area, or in Wales and Scotland, than in, say, London or the South East.

According to the UK Office for National Statistics the chances of your business surviving are best in Northern Ireland, where just over 70 per cent are still going after three years, and worst in London, where around 60 per cent of businesses remain after three years.

Select Database, a direct marketing firm, has a nifty database that can tell you how many businesses have been set up recently in any postal district in the UK (www.selectabase.co.uk/startupsplus).

Winning with women

Women in Europe currently own less than a third of small businesses, but women start about 35 per cent of new businesses in the UK. Businesses started by women tend to be concentrated in the labour-intensive retail industries, where management skills are particularly valuable.

The British Association of Women Entrepreneurs (www.bawe-uk.org) and Everywoman (www.everywoman.co.uk) are useful starting points to find out more about targeted help and advice for women starting up a business.

Self-employment, a term used interchangeably with starting a business, tends to be a mid-life choice for women, with the majority starting up businesses after the age of 35. Self-employed women usually have children at home (kudos to these super-mums), and many go the self-employment route *because* they have family commitments. In most cases, self-employment grants greater schedule flexibility than the rigours of a nine to five job.

The types of businesses that women run reflect the pattern of their occupations in employment. The public administration, education and health fields account for around a quarter of self-employed women, and distribution, hotels and restaurants another fifth.

In financing a new business, women tend to prefer using personal credit cards or remortgaging their home, and men prefer bank loan finance and government and local authority grants.

Being educated about education

A popular myth states that undereducated self-made men dominate the field of entrepreneurship. Anecdotal evidence seems to throw up enough examples of school or university drop-outs to support the theory that education is unnecessary, perhaps even a hindrance, to getting a business started. After all, if Sir Richard Branson (Virgin) could drop out of full time education at 16, and Lord Sugar (Amstrad), Sir Philip Green (BHS and Arcadia, the group that includes Topshop and Miss Selfridge), Sir Bernie Ecclestone (Formula One – Britain's tenth richest man) and Charles Dunstone (Carphone Warehouse) could all give higher education a miss, education can't be that vital.

However, the facts, such as they are, show a rather different picture. Research shows that the more educated the population, the more entrepreneurship takes place. Educated individuals are more likely to identify gaps in the market or understand new technologies. After all, Stelios Haji-Iannou, founder of easyJet, has six degrees to his name, albeit four are honorary. Tony Wheeler, who together with his wife Maureen founded Lonely Planet Publications, has degrees from Warwick University and the London Business School. Jeff Bezos (Amazon) is an alumnus of Princeton and Google's founders, Sergey Brin and Larry Page, graduated from Stanford.

So if you're in education now, stay the course. After all, a key characteristic of successful business starters is persistence and the ability to see things through to completion. Chapter 3 outlines more entrepreneurial attributes.

Coming Up with a Winning Idea

Every business starts with the germ of an idea. The idea may stem from nothing more profound than a feeling that customers are getting a raw deal from their present suppliers.

In this section you can find out some tried-and-tested ways to help you come up with a great idea for a new business.

Ranking popular start-up ideas

The government's statistics service produces periodic statistics on the types of businesses operating in the UK.

In terms of the sheer number of business enterprises, the United Kingdom is more a nation of estate agents than of small shopkeepers, as demonstrated in Table 2-1 that shows the types of businesses being operated in Britain in 2010, according to government statistics (http://stats.bis.gov.uk/ed/sme).

Table 2-1 Businesses Operating by Sector, 2010

Sector	*Total*
Real estate, renting and business activities	1,206,505
Construction	1,009,725
Wholesale and retail trade; repairs	583,280
Other community, social and personal service activities	502,630
Manufacturing	324,330
Transport, storage and communication	294,800
Health and social work	265,585
Agriculture, hunting and forestry; fishing	174,315
Education	168,305
Hotels and restaurants	164,105
Financial intermediation	74,160
Mining and quarrying; electricity, gas and water supply	15,545
All industries	*4,783,285*

You can take one of two views on entering a particularly popular business sector. Either it represents a great idea you're mad to resist, or the business is already awash with competition. In practice, the best view to take is that if others are starting up at least a market opportunity exists. Your task is to research the market thoroughly, using Chapter 4 as your guide.

Going with fast growth

Entrepreneur.com produces an annual list of hot business sectors to enter (www.entrepreneur.com/trends). The 2010 list includes:

- **Buy local:** The buy local ethos has its roots in the farmers' markets movement but the big supermarket chains are getting in on the act, devoting sections of shelf space to local wares.
- **Discount retailing:** Pound and second-hand businesses are booming on both sides of the Atlantic. The Americans even have a trade association for the sector, the National Association of Resale Professionals.
- **Education:** The lack of jobs has sent millions around the globe back to college to train or retrain. Universities in the UK are full to bursting point. Unsurprisingly, a boom is occurring in online learning, tutoring and other private learning facilities.
- **Green energy and renewable:** A growing sector because governments the world over are chucking what little money they have at this.
- **Senior market:** With the population of over 64s exploding, this is a no-brainer sector to serve. Academics, always quick to latch on to opportunities, have singled out *gerontology* (the study of social, psychological and biological aspects of aging with the view of extending active life whilst enhancing its quality)

as one of the hottest areas, with a university scheduled to debut a new master's degree in aging-services management to meet the growing interest in the field.

You can use this information to help pick a fast-growing business area to start your business in. Beginning with the current flowing strongly in the direction you want to travel makes things easier from the start.

Spotting a gap in the market

The classic way to identify a great opportunity is to see something that people would buy if only they knew about it. The demand is latent, lying beneath the surface, waiting for someone – you, hopefully – to recognise that the market is crying out for something no one is yet supplying.

These are some of the ways to go about identifying a market gap:

- **Adapting:** Can you take an idea that's already working in another part of the country or abroad and bring it to your own market?
- **Locating:** Do customers have to travel too far to reach their present source of supply? This is a classic route to market for shops, hairdressers and other retail-based businesses, including those that can benefit from online fulfilment.
- **Size:** If you made things a different size, would that appeal to a new market? Anita Roddick of The Body Shop found that she could only buy the beauty products she wanted in huge quantities. By breaking down the quantities and sizes of those products and selling them, she unleashed a huge new demand.

- **Timing:** Are customers happy with current opening hours? If you opened later, earlier or longer, would you tap into a new market?

Revamping an old idea

A good starting point is to look for products or services that used to work really well, but have stopped selling. Ask yourself why they seem to have died out and then try to establish whether, and how, that problem can be overcome. Or you can search overseas or in other markets for products and services that have worked well for years in their home markets but have so far failed to penetrate into your area.

Sometimes with little more than a slight adjustment you can give an old idea a whole new lease of life. For example, the Monopoly game, with its emphasis on the universal appeal of London street names, has been launched in France with Parisian *rues* and in Cornwall using towns rather than streets.

Using the Internet

Many of the first generation of Internet start-ups had nothing unique about their offer, the mere fact that the business was ‘on the net’ was thought to be enough. Hardly surprisingly, most of them went belly-up in no time at all.

All the basic rules of business apply to Internet businesses. You need a competitive edge – something better and different about your product or service that makes you stand out from the crowd.

However, you also need something about the way you use the Internet to add extra value over and above the traditional ways in which your product or service is sold. Online employment agencies, for example, can add value to their websites by offering clients and applicants useful information such as interview tips, prevailing wage rates and employment law updates.

But using the Internet to take an old idea and turn it into a new and more cost-efficient business can be a winner. Check out the example in the nearby ‘Winning on the net’ sidebar. Chapter 15 is devoted exclusively to the subject of making a success of getting online and making money.

Solving customer problems

Sometimes existing suppliers just aren’t meeting customers’ needs. Big firms very often don’t have the time to pay attention to all their customers properly because doing so just isn’t economic. Recognising that enough people exist with needs and expectations that aren’t being met can constitute an opportunity for a new small firm to start up.

Winning on the net

Harold had worked in a car salvage business for five years when he decided he wanted to be his own boss. The salvage business consists largely of broken-down cars, rusty puddles of water and lots of used notes changing hands – an unlikely e-business environment.

His employer had two sites situated strategically at motorway junctions to cover as much of the country as possible. When recovered from an accident, the insurance company assesses the vehicle – those that are beyond repair are sold for scrap after the spare parts have been salvaged. Harold's employer, or one of his competitors, sold the rest at auction. Historically, all vehicles were held and sold at the company's premises, which effectively acts as a car showroom. Prospective purchasers visited, viewed and bought vehicles in the traditional way, much like a second-hand car dealership. This meant that traders who were located in prime positions had access to both the best buys and the best customers. Some customers from out of the area visited occasionally, but not often because it was too time consuming to take a day out browsing on the off chance of finding a good deal.

But for Harold, having a prime site was too expensive a proposition. He'd read about e-business and felt that it offered the possibilities of opening up the market to entice more buyers into an auction. Also, if the auctions were conducted online, Harold could use a less expensive site to store the vehicles, because access was less important to buyers, who could have their purchases delivered to them.

Harold bought an off-the-shelf software package that enabled him to come up with a no-mess, no-fuss website. He had all the features of an online auction up and working within six weeks and ran a promotional campaign including advertising in local and trade publications. He emailed his network of business contacts to start spreading the news by word of mouth.

Over 100 serious buyers attend Harold's online auctions, which compares with a comparable physical auction that is lucky to attract 50. Having a wider and larger audience ensures better prices too.

Harold started small with just a dozen cars for sale, but quickly built up his stock. He was able to do this because all his vehicles were sold and paid for in a matter of days. His previous employer took up to three months to get his money back after buying in stock.

Start by recalling the occasions when you've had reason to complain about a product or service. You can extend that by canvassing the experiences of friends, relatives and colleagues. If you spot a recurring complaint, that may be a valuable clue about a problem just waiting to be solved.

Next you can go back over the times when firms you've tried to deal with have put restrictions or barriers in the way of your purchase. If those restrictions seem easy to overcome, and others share your experience, then you may well be on the trail of a new business idea.

Giving readers what they like

For Tim Waterstone, the basic concept of his bookshop chain, Waterstone's, came from wandering around Manhattan bookshops on his frequent trips to the US. They were brilliant places: lively and consumer led with huge stocks, accessible staff and long opening hours. He felt that book buyers in Britain were frustrated at not being able to browse outside normal working hours, because bookshops in the UK stuck pretty much to regular shop opening times. Also, shop assistants who knew about merchandising but little or nothing about books staffed the shops. This meant that unless a customer knew exactly what book she was looking for, she was unlikely to get much help to find it.

Although Waterstone felt he was on to a winning idea, at the time he did nothing about it because he had a job. But after he was made redundant, a trip to the dole office acted as a catalyst. It was the most horrific experience of his life. Not waiting for his turn, he rushed out and sat in his car. Instead of trying to get a new job, he formulated the Waterstone's concept. High-street banks turned him down. He then went to a finance house and struck lucky. He pledged his house and committed £6,000 savings and £10,000 borrowed from his father-in-law, and raised the rest through the government's Small Firms Loan Guarantee Scheme (SFLG). Three months later, the first Waterstone's opened.

Based on a simple store plan that an art student sketched out for £25, Waterstone filled the shop with the type of books that appeal to book lovers, not bestseller buyers. Late hours, Sunday trading (where possible) and bonus schemes for his highly literate staff led to dazzling sales. Within eight years, Waterstone's had some 40 shops employing 500 people, with a turnover of £35 million plus. Tim Waterstone sold the business to stationery chain WH Smith for nearly £60 million and was invited to stay on and run it less than a decade after his dole queue experience. Now part of HMV Group, Waterstone's currently trades from more than 300 stores and its flagship branch on Piccadilly in London is the biggest bookshop in Europe.

Creating inventions and innovations

Inventions and innovations are all too often almost the opposite of either identifying a gap in the market or solving an unsolved problem. Inventors usually start by looking through the other end of the telescope. They find an interesting problem and solve it. There may or may not be a great need for whatever it is they invent.

The Post-it note is a good example of inventors going out on a limb to satisfy themselves rather than to meet a particular need or even solve a burning problem. The story goes that scientists at 3M, a giant American company, came across an adhesive that failed most of their tests. It had poor adhesion qualities because it could be separated from anything it was stuck to. No obvious market existed, but they persevered and pushed the product on their marketing department, saying that the new product had unique properties in that it stuck 'permanently, but temporarily'. The rest, as they say, is history.

Never go down the lonely inventor's route without getting all the help and advice you can get. Chapter 7 gives you details of organisations that can smooth your path from the bench to the market. You should also make sure that someone else hasn't already grabbed your innovation, and that you can put a legal fence around it to keep rustlers out. I deal with copyrights, patents and the like in Chapter 5.

Marketing other people's ideas

You may not have a business idea of your own, but nevertheless feel strongly that you want to work for yourself. This approach isn't unusual. Sometimes an event such as redundancy, early retirement or a financial windfall prompts you to searching for a business idea.

Business ideas very often come from the knowledge and experience gained in previous jobs, but take time to come into focus. Usually, you need a good flow of ideas before one arrives that appeals to you and appears viable.

You can trawl for ideas and opportunities in any number of ways:

- **Browse websites.** The Internet is a great source of business ideas. Try Entrepreneurs.com (www.entrepreneur.com/bizoppzone), which lists hundreds of ideas for new businesses, together with information on start-up costs and suggestions for further research. It also has a series of checklists to help you evaluate a business opportunity to see whether it's right for you. Home Working (www.homeworkinguk.com) lists dozens of current business ideas exclusively aimed at the British market.

- **Read business magazines.** Periodicals such as *Start Your Business* magazine (www.sybmagazine.com) present the bones of a number of ideas each month.
- **Scan papers and periodicals.** Almost all papers and many general magazines too have sections on opportunities and ideas for small businesses.

When answering advertisements for other people's business ideas, do take precautions to ensure that you aren't about to become a victim of a fraudulent venture. The Advertising Standards Authority (ASA) warns that not all 'get rich quick' offers are genuine. These advertisements can lure even quite sophisticated people into bogus schemes. The ASA believes that 'fooling all of the people all of the time' is entirely possible when the product or service is interesting or persuasive enough. Recent complaints include a mailshot saying: 'No more telephone bills for you – ever.' For £7.50, GP Services of Huntingdon offered to disclose details of a technique that had been 'tried, tested and proven', required no equipment or capital and was 'currently being used throughout the UK'. The method was just to contact British Telecom's customer services department and ask to be disconnected. Upholding complaints against the firm, the authority ruled that it 'exploited consumers' credulity'.

The ASA (www.asa.org.uk) publishes a quarterly list of complaints that it's considered or is investigating. Also check out websites such as www.scambusters.org, www.scam.com and www.fraudguides.com, which track the latest wheezes doing the rounds both on- and offline.

Being better or different

To have any realistic hope of success, every business opportunity must pass one crucial test: the idea or the way the business is to operate must be either different from or better than any other business in the same line of work. In other words you need a *unique selling proposition* (USP), or its Internet equivalent, a *killer application*.

The thinking behind these two propositions is that your business should have a near unbeatable competitive advantage if your product or service offers something highly desirable that others in the field can't easily copy: something that only you can offer. Dyson's initial USP was the bagless cleaner, and Amazon's was 'one-click' shopping, a system for retaining customer details that made buying online a less painful experience.

> Inventors need to be persistent. James Dyson took five years and 5,127 prototypes to produce the world's first bagless vacuum cleaner. The result was so successful that, despite patent protection, Hoover tried to imitate the product. Dyson then had an 18-month legal battle on his hands before he finally won a victory against Hoover for patent infringement.

The trick with USPs and killer applications doesn't just lie with developing the idea in the first place, but making it difficult for others to copy it. (Chapter 5 suggests ways to protect your USP.)

If neither you nor the product or service you're offering stands out in some way, then why on earth would anyone want to buy from you? But don't run off with the idea that only new inventions have any hope of success. Often just doing what you say you'll do, when you say you'll do it, is enough to make you stand out from the crowd.

That was all Tom Farmer did when he founded Kwik-Fit. He put his finger on the main criticisms people had of garages. The experience of getting an exhaust fitted or tyres changed was made seriously unpleasant simply because you couldn't rely on the garage's cost estimate or be sure when your car would be ready. The message always was, ring us at 4 p.m. and we'll let you know.

Farmer's big idea was simply to make promises he could keep, to meet deadlines and to keep to estimated costs. And wow, that was enough to build a business that the Ford Motor Company thought was worth the billion pounds it paid for it. I point out ways to test the feasibility of your business idea in Chapter 4.

Banning Bad Reasons to Start a Business

You may have any number of good reasons to start a business, just make sure you're not starting a business for the wrong reasons – some of which I explore in the following sections.

Steering clear of bad assumptions

You need to be sure that your business idea isn't a lemon. You can't be sure that you have a winning idea on your hands, but you can take some steps to make sure you avoid obvious losers. Much as you want to start a business, it won't help you if you get in over your head because you start from a bad premise, such as those in the following list:

- **The market needs educating.** You may think you have a situation in which the market doesn't yet realise it can't live without your product or service. Many early Internet businesses fitted this description and look what happened to them. If you think customers have to be educated before they purchase your product, walk away from the idea and leave it to people with deep pockets and a long time horizon; they'll need them.
- **We're first to market.** Gaining 'first-mover advantage' is a concept used to justify a headlong rush into a new business, but as I explain in Chapter 1, the idea is probably incorrect.
- **If we can get just 1 per cent of the market we're on to a winner.** No markets exist with a vacant percentage or two just waiting to be filled. Entering almost any market involves displacing someone else, even if your product is new. Po Na Na, a chain of late-night souk bars, failed despite being new and apparently without competitors. If the company had captured just 1 per cent of the dining market instead of 100 per cent of the souk-eating student market, it may have survived. But the dining market had Italian, Indian, Greek and French competitors already in place. This, when combined with the vastly improved range of ready-to-eat meals from the supermarket, means that companies fight bitterly over every hundredth of a per cent of this market.

Every business begins with an idea, but it doesn't necessarily have to be your own idea. It has to be a viable idea, which means that the market has to contain customers who want to buy from you. And enough of them have to exist to make you the kind of living you want. It may be an idea that you've nursed and investigated for years, or it may be someone else's great idea that's just too big for her to exploit on her own. A franchised business is one example of a business idea that has room for more than one would-be business starter to get involved with. Franchises can be run at many levels, ranging from simply taking up a local franchise, through to running a small chain of two to five such franchises covering neighbouring areas.

Avoiding obvious mistakes

Your enthusiasm for starting a business is a valuable asset as long as you don't let it blind you to some practical realities. The following list contains some reasoning to resist.

- **Starting in a business sector of which you have little or no previous knowledge or experience.** The grass always looks greener, making business opportunities in distant lands or in technologies with which you have only a passing acquaintance seem disproportionately attractive. Taking this route leads to disaster. Success in business depends on superior market knowledge from the outset and sustaining that knowledge in the face of relentless competition.
- **Putting in more money than you can afford to lose, especially if you have to pay up front.** You need time to learn how business works. If you've spent all your capital and exhausted your capacity for credit on the first spin of the wheel, then you're more a gambler than an entrepreneur. The true entrepreneur takes only a calculated risk. Freddie Laker, who started the first low-cost no-frills airline, bet everything he could raise on buying more planes than he could afford. To compound the risk he bet against the exchange rate between the pound and the dollar, and lost. Learn from Mr Laker's mistake.

- **Pitting yourself against established businesses before you're strong enough to resist them.** Laker also broke the third taboo: he took on the big boys on their own ground. He upset the British and American national carriers on their most lucrative routes. There was no way that big, entrenched businesses with deep pockets would yield territory to a newcomer without a fight to the death. That's not to say that Laker's business model was wrong. After all, Ryanair and easyJet have proved that it can work. But those businesses tackled the short-haul market to and from new airfields and, in the case of easyJet, at least started out with tens of millions of pounds of family money that came from a lifetime in the transportation business.

Recognising that the Economy Matters

The state of the economy in general has an effect both on the propensity of people to start a business and on their chances of survival. Although business cycles have no doubt been in existence for centuries, a serious study of the subject is barely 150 years old. Joseph Schumpeter, the American economist who more or less invented the subject of economics, defines the cycle itself as 'the economic ebb and flow that defines capitalism.' 'Cycles,' he wrote, 'are not, like tonsils, separable things that might be treated by themselves, but are, like the beat of the heart, of the essence of the organism that displays them.' In a later work he went on to claim that business enterprises operate in 'the perennial gale of creative destruction'. This creative destruction – the term for which Schumpeter is perhaps best remembered – is the by-product of the continuous stream of innovation; the more radical the innovation – steam, electricity, the Internet – the more violent the cycle.

Spotting cycles

Seeing a business cycle on the horizon would be a doddle if there weren't so many of them and they weren't all so different! At least four competing, overlapping and even contradictory theories exist about the shape and form of business cycles, including:

- **The Juglar Cycle,** named after Clement Juglar, a French economist who studied interest rate and price changes in the 1860s and observed boom and bust waves of 9 to 11 years going through four phases in each cycle:
  - **Prosperity:** Where investors rushed into new and exciting ventures
  - **Crisis:** When business failures started to rise
  - **Liquidation:** When investors pull out of markets
  - **Recession:** When the consequences of these failures begin to be felt in the wider economy in terms of job losses and reduced consumption
- **The Kitchen Cycle,** also known as the inventory cycle, named after Joseph Kitchin who discovered a 40-month cycle resulting from a study of US and UK statistics from 1890 to 1922. When demand appears to be stronger than it really is, companies build and carry too much inventory, leading people to overestimate likely future growth. When that higher growth fails to materialise, inventories are reduced, often sharply, so inflicting a 'boom, bust' pressure on the economy.

- **Kondratieff's theory** was that the advent of capitalism had created long wave economic cycles lasting around 50 years. His theories received a boost when the Great Depression (1929–1933) hit world economies. The idea of a long wave is supported by evidence that major enabling technologies from the first printing press to the Internet take 50 years to yield full value, before themselves being overtaken.
- **Kuznet's Cycle**, proposed by Simon Kuznet, is based around the proposition that it takes 15 to 25 years to acquire land, get the necessary permissions, build property and sell. Also known as the Building Cycle, this theory has credibility because so much of economic life is influenced by property and the related purchases of furniture and associated professional charges, for example for lawyers, architects and surveyors.

Since 1900 27 *bull markets* have existed in the UK, roughly corresponding to the upswing of an economic cycle, when brands can rise sharply with the incoming economic tide. For every bull market a corresponding *bear market* exists, when overoptimistic firms get mauled because the bottom drops out of stock markets.

Preparing for the ups and downs

Clearly, it would be helpful if business starter could have warning in advance about the likelihood of a downturn. In much the same way as a shipping forecast helps sailors trim their boats before a storm, some advance warning would let businesses do the same. Sailors don't need to have a detailed knowledge of what causes tides, currents and winds, just an indication of when a change is likely to occur and how serious and prolonged the event will be. Information on the timing, strength, shape and path of the downturn stage of an economic cycle would help managers.

People generally understand and recognise the broad shape of the effect of the economic cycle on output, in other words total demand for goods and services. (See Figure 2-1). But a few caveats to this pattern exist. A Double dip can occur with two downturns before recovery gets properly underway) and occasionally long periods of flat lining can occur, where the economy virtually stands still, neither growing or contracting.

Unfortunately, no one has yet come up with a reliable way of anticipating the turning points in cycles. Only two economists, Friedrich von Hayek and Ludwig von Mises, forecasted the stock market crash of 1929. The Harvard Economics Society concluded in November after the 1929 crash that ‘a depression seems improbable; we expect a recovery of business next spring with further improvements in the fall’. In fact, the Society was to dissolve itself before the depression was halfway through its life. All economic cycles are easy to predict, apart from the one you’re in, is the helpful guidance on offer from most academic economists.

Maynard Keynes, the famous British economist, described the cause of the violent and unpredictable nature of the business cycle as ‘animal spirits’, or people’s tendency to let emotions, particularly swings from excessive optimism to excessive pessimism, influence their economic actions. In short, the business cycle is all down to how millions of people feel!

Two schools of thought exist on whether starting a business is more difficult when the economy is contracting, corresponding to whether you subscribe to the belief that a glass is half full or half empty. On the one hand fewer competitors are in the market, because many have failed. But on the other hand those remaining are both seasoned warriors and more desperate to keep what small amount of business exists to themselves.

In real life most people start a business when they want to and not at a favourable stage in the economic cycle. That, however, doesn't mean that you can simply ignore the economy. In much the same way as a prudent sailor pays attention to the state of the tide, you need to see whether the general trend of the economy is working with or against you.

If you have a choice of when to start up, having the current working for you is usually better than having it against you, so choose to open your business during an economic upswing, if possible.

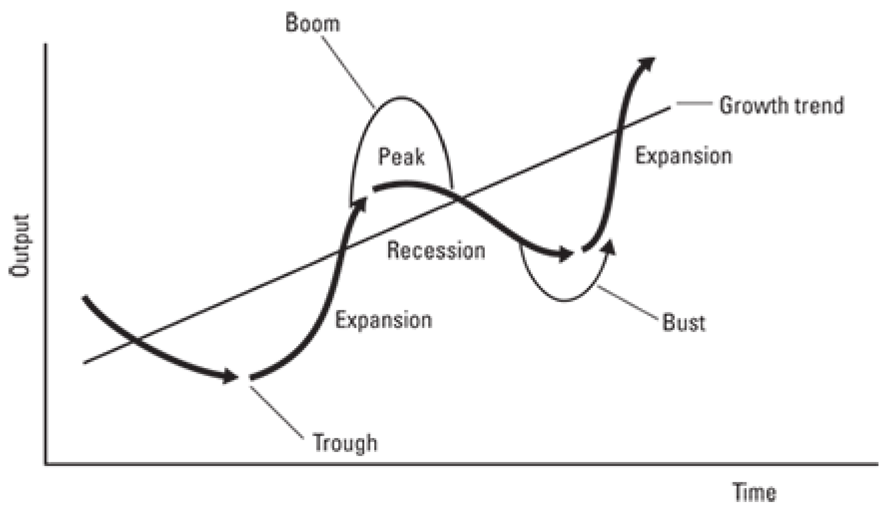


Figure 2-1: Typical path of an economic cycle.

Preparing to Recognise Success

To be truly successful in running your own business you have to both make money and have fun. That's your pay-off for the long hours, the pressure of meeting tough deadlines and the constant stream of problems that accompany most start-up ventures.

One measure of success for any business is just staying in business. That's not as trite a goal as it sounds, nor is it easily achieved, as you can see by looking at the number of businesses that fail each year.

However, survival isn't enough. Cash flow, which I talk about in Chapter 8, is the key to survival, but becoming profitable and making worthwhile use of the assets you employ determine whether staying in business is really worth all your hard work.

Measuring business success

No one in their right mind sets out to run an unsuccessful business, although that's exactly what millions of business founders end up doing. Answering the following questions can act as a check on your progress and keep you on track to success.

- **Are you meeting your goals and objectives?** In Chapter 6 I talk about setting down business goals. Achieving those goals and objectives is both motivational and, ultimately, the reason you're in business.
- **Are you making enough money?** This sounds like a daft question, but it may well be the most important one you ask. The answer comes out of your reply to two subsidiary questions:
  - **Can you do better by investing your time and money elsewhere?** If the answer to this question is yes, then go back to the drawing board with your business idea.

  - **Can you make enough money to invest in growing your business?** The answer to this question only becomes clear when you work out your profit margins, which I cover in Chapter 13. But the fact that many businesses don't make enough money to reinvest in themselves is pretty evident when you see scruffy, run-down premises, worn-out equipment and the like.

- **Can you work to your values?** Anita Roddick's Body Shop had a clearly articulated set of values that she and every employee bought into. Every aspect of the business from product and market development down to the recruitment process promoted this value system – if you weren't green you didn't join. Ms Roddick's philosophy may have been a little higher than you feel like going, but values can help guide you and your team when the going gets tough.

Exploring the myth and reality of business survival rates

Misinformation continually circulates about the number of failing businesses. The most persistent and wrong statistic is that 70 per cent (some even quote 90 per cent) of all new businesses fail. The failure rate is high, but not that high, and in any case the term *failure* itself, if people use the word to mean a business closing down, has a number of subtly different nuances.

Millions of small businesses start up, but many of these survive for only a relatively short time. Over half of all independently owned ventures cease trading within five years of starting up. However, if you can make it for five years, the chances of your business surviving increase dramatically from earlier years.

The Office of the Official Receiver lists the following causes for business failures:

- **Bad debts:** Unfortunately, having great products and services and customers keen to buy them is only half the problem. The other half is making sure that those customers pay up on time. One or two late or non-payers can kill off a start-up venture. In Chapter 13 you can find strategies to make sure that you get paid and aren't left in the lurch.
- **Competition:** Without a sound strategy for winning and retaining customers, your business is at the mercy of the competition. In Chapter 10 you can discover how to win the battle for the customer.
- **Excessive remuneration to the owners:** Some business owners mistake the cash coming into the business for profit and take that money out as drawings. They forget that they have to allow for periodic bills for tax, value added tax (VAT), insurance and replacement equipment before they can calculate the true profit, and hence what they can safely draw out of the business. In Chapter 13 you can discover how to tell profit from cash and how to allow for future bills.
- **Insufficient turnover:** This can happen if the fixed costs of your business are too high for the level of sales turnover achieved. Chapter 13 shows how to calculate your break-even point and so keep sales levels sufficient to remain profitable.
- **Lack of proper accounting:** Often business founders are too busy in the start-up phase to keep track of the figures. They often pile up invoices and bills to await a convenient moment when they can enter these in the accounts. But without timely financial information you

may miss key signals or make wrong decisions. In Chapter 13 you can read about how to keep on top of the numbers.

- **Not enough capital:** You, along with most business start-ups, may hope to get going on a shoestring. But you need to be realistic about how much cash you need to get underway and stay in business until sales volumes build up. In Chapter 8 you can see how to plan your cash flow so that you can survive.
- **Poor management and supervision:** You may well know how your business works, but sharing that knowledge and expertise with those you employ isn't always that easy. In Chapter 11 you see how to manage, control and get the best employees to give of their best.

Chapter 3

Can You Do the Business?

In This Chapter

- Understanding whether being your own boss is right for you
- Checking out various ventures
- Setting up your business at home
- Figuring out your profit motive
- Taking a skills inventory to identify any gaps

Governments are keen to foster entrepreneurship: new businesses create jobs for individuals and increased prosperity for nations, which are both primary goals for any government. If those new firms don't throw people out of work when recessions start to bite, supporting them becomes doubly attractive.

But people, you included, don't start businesses or grow existing ones simply to please politicians or to give their neighbours employment. They have many reasons for considering self-employment. The idea of escaping the daily grind of working for someone else and being in charge of their own destiny attracts most people. But despite the many potential benefits, they face real challenges and problems, and self-employment isn't a realistic option for everyone.

The questions you need to ask yourself are: Can I do it? Am I really the entrepreneurial type? What are my motivations and aims? How do I find the right business for me? This chapter can help you discover the answers.

Deciding What You Want From a Business

See whether you relate to any of the most common reasons people give for starting up in business:

- Being able to make your own decisions
- Having a business to leave to your children
- Creating employment for the family
- Being able to capitalise on specialist skills
- Earning your own money when you want
- Having flexible working hours
- Wanting to take a calculated risk
- Reducing stress and worry
- Having the satisfaction of creating something truly your own
- Being your own boss
- Working without having to rely on other people

The two central themes connecting all these reasons seem to revolve around gaining personal satisfaction – making work as much fun as any other aspect of life – and creating wealth – essential if an enterprise is going to last any length of time.

Even when your personality fits and your goals are realistic, you have to make sure that the business you're starting is a good fit for your abilities.

The following sections explore these reasons in more detail.

Gaining personal satisfaction (or, entrepreneurs just wanna have fun)

No one particularly enjoys being told what to do and where and when to do it. Working for someone else's organisation brings all those disadvantages. When you work for yourself, the only person to blame if your job is boring, repetitive or takes up time that you should perhaps spend with family and friends is yourself.

Another source of personal satisfaction comes from the ability to 'do things my way'. Employees are constantly puzzled and often irritated by the decisions their bosses impose on them. All too often managers in big firms say that they'd never spend their own money in the way the powers that be encourage or instruct them to do. Managers and subordinates alike feel constrained by company policy, which seems to set out arbitrary standards for dealing with customers and employees in the same way.

> The high failure rate for new businesses suggests that the glamour of starting up on their own seduces some people who may be more successful and more contented in some other line of endeavour.

Running your own firm allows you to do things in a way that you think the market, and your employees, believe to be right at the time.

Making money

Apart from winning the lottery, starting your own business is the only possible way to achieve full financial independence. But it isn't risk free. In truth, most people who work for themselves don't become mega rich. However, many do and many more become far wealthier than they would probably have become working for someone else.

You can also earn money working at your own pace when you want to and even help your family to make some money too.

Running your own business means taking more risks than you do if you're working for someone else. If the business fails, you stand to lose far more than your job. If, like most owner managers, you opt for *sole trader status* – someone working usually on his own without forming a limited company (find more on business categories in Chapter 5) – you can end up personally liable for any business debts you incur. This can mean having to sell your home and other assets to meet your obligations. In these circumstances, not only will all your hard work have been to no avail, but you can end up worse off than when you started. Also, winding up a business is far from fun or personally satisfying.

I don't want to discourage you, just to apply a reality check. The truth is that running your own business is hard work that often doesn't pay well at first. You have to be okay with those facts in order to have a chance of success.

Fighting poverty through trade

Traidcraft's mission is to fight poverty through trade, practising and promoting approaches to trade that help poor people in developing countries transform their lives. The company has more than 450 different products sourced from more than 100 producer groups in almost 30 developing countries, selling through its nationwide network of fair traders and online shop. Traidcraft raises funds and gives aid, help and advice to the tune of £1.5 million a year to help enterprises in developing countries. Projects include improving market access for women producers in Vietnam; helping Indian tea workers achieve sustainable livelihoods; and analysing the dairy sector in Kenya, identifying key constraints affecting smallholder dairy farmers and their access to markets. Traidcraft received the Queen's Award for Industry for Sustainable Development, along with a host of other awards. Oh, and it does a pretty good job of making money too – with £15 million turnover each year, business has been growing at an average of 18 per cent a year, making a return on capital of 10 per cent. More details are on the company's website, www.traidcraft.co.uk/socialaccounts.

Saving the planet

Not everyone has making money as their sole aim when setting up in business. According to the government's figures, around 20,000 'social entrepreneurs' run businesses aiming to achieve sustainable social change and trade with a social or environmental purpose. They contribute almost £25 billion to the national economy and assist local communities by creating jobs, providing ethical products and services using sustainable resources and reinvesting a share of the profits back into society.

Ethical businesses have some unique advantages. For example, according to those running such firms they can relatively easily attract and retain intelligent people. Over 70 per cent of students say that a potential employer's track record is an important factor in job choice. Customers also like ethical firms. According to a recent European Union survey on sustainable consumption, 86 per cent of those polled in the United Kingdom, Spain, Germany, Greece and Italy said that they felt very strongly about wanting things to be produced and marketed responsibly. They also blamed brands for not providing more environmentally and socially friendly products.

If you want to explore the prospects for starting a social enterprise, contact the School for Social Entrepreneurs (website: www.sse.org.uk; tel: 020 8981 0300), which can help with specific and tailored support. If you need funds to start a social enterprise, contact Bridges Community Ventures (website: www.bridgesventures.com; tel: 020 7262 5566), a venture capital firm with a social mission. Its founding principle is that all the funds it invests go to businesses with a clear social purpose as well as aiming to achieve financial returns for investors.

Exploring Different Types of Business

At one level all businesses are the same – they sell something to people who want to buy from them, while trying to make an honest buck along the way. At another level many very different types of business and ways of doing business exist, even within what superficially can appear to be very similar fields.

Selling to other businesses

Business-to-business (B2B) enterprises, such as those selling market research, database management, corporate clothing, management consultancy, telemarketing or graphic design, involve one businessperson selling to another. The attractions are that you're dealing with other people who have a definite need and usually buy in relative large quantities and at regular intervals. For example, an individual may buy envelopes in packs of a dozen a few times a year, but a business buys scores, perhaps even thousands, and puts in an order every month. Corporate customers are harder to win, but are often worth more when you have them. And unlike private individuals, businesses like to forge relationships that endure over time.

Some downsides exist too. Business customers expect credit, perhaps taking between 60 and 90 days to pay up. If they go bust they may owe a lot of money and take some of their suppliers down with them. You may have to attend exhibitions to make your presence known, a costly and time-consuming process, or advertise in trade directories. Check out these websites to find out more about these topics: www.idealbusinessshow.co.uk and www.b2bindex.co.uk.

Opening all hours

Conventional shops, restaurants and the like have long opening hours and have to meet the expectations of increasingly savvy consumers, whose access to the Internet has made them aware of competitive prices as well as high specifications and standards of service. The upside of any form of retailing is that you're almost invariably paid up front. But just because you get the cash in your hand doesn't mean that you don't have to meet exacting standards. Customers are protected in their dealings in a myriad of ways and if you fall short of their legal entitlement you can end up with a bigger bill than a simple cash refund. (I cover legal issues in Chapter 10, 'Marketing Your Wares'.) In conventional retailing you also have to rent premises and stock them with products, both factors that can add significantly to the business risk.

Increasingly, new retail business start-ups are Internet based. The website is in effect the shop window and the stock of products being sold may even be in a warehouse owned by a third party. This keeps up-front costs down but means keeping abreast of fast-changing technologies – the Internet, servers and computer hardware and software. (I look at these in more depth in Chapter 15.)

Making products

One of the attractions of manufacturing is that you have a greater degree of control over the quality, cost and specification of the end product than a retailer or wholesaler might. But with those advantages come some hefty penalties. Factories, equipment, stocks of raw materials and employees are costly overheads. You have to incur these expenses well before you're certain of any orders – an unlikely way into business for someone without previous manufacturing experience and a deep wallet. Such owners also bear some significant risks towards their employees. The UK manufacturing sector reports over 32,000 work-related accidents to the Health and Safety Executive each year. This figure includes over 6,200 major injuries such as fractures and amputations as well as around 40 fatalities.

A more likely route to manufacturing for a new business is subcontracting, where you're working for a manufacturer on part of a product. The most common examples of subcontractors are plumbers, electricians and carpenters in building work, metal and plastic casing production and the like in civil engineering and a wide range of activities in the information technology sector.

Servicing customers

Service industries now dominate the British economy and account for around 70 per cent of gross domestic product (the value of the goods and services that the country produces). Services include financial intermediaries, hairdressing, real estate, computer services, research and development, education, health and social work, refuse disposal, recreational, cultural and sporting activities and an extensive range of other activities where no physical goods play a major part in any transaction. In truth, however, most manufactured goods include a service element, though the business functions are often separated. For example, manufacturing businesses produce cars but are quite separate from the garage chains that repair those vehicles. But some manufacturers go further – Dell manufactures computers and also carries out delivery and many other service functions.

Service businesses require a high degree of personal involvement and as such call for founders who see their people skills as pivotal. In a nutshell, if you don't enjoy understanding the intimate details of what makes customers tick and then going out of your way to meet their needs, running a service business may be of little appeal.

Working from Home

Few dedicated statistics exist on the number of people operating home-based enterprises as distinct from those setting up in dedicated premises. IDC, a US-based research firm, claims that around 18 million of the 29 million owner-managed businesses in US are home based. US census data shows that 17.6 million businesses employ no one but the boss. Put these two facts together and working on the reasonable assumption that the majority of home-based businesses are one-man (and one-woman) bands, then around two thirds of all small business would appear to be home based. Even those not working from home now often start out from there, like the founders of Blooming Marvellous (see the nearby sidebar).

Blooming Marvellous

Judy Lever and Vivienne Pringle started Blooming Marvellous literally on a kitchen table back in 1983. Having attended a business start-up course in Kensington, London run by the author, they put further flesh onto their big idea. Both were pregnant, and after searching for the kind of fashionable clothes they used to wear and drawing a blank they guessed they'd found a gap in the market. They kept on their day jobs and would meet after work every day at Judy's house to answer enquiries, send out leaflets and despatch products out in the post every day. They outsourced work to a pattern cutter, a small factory, some fabric suppliers and eventually to a small distribution centre. After a year or so of modest sales they felt confident enough to set up their first business premises – a 1,200 square foot warehouse on a business park staffed by four of the women who'd been working in their distribution centre.

Eventually, the company employed 150 people in 14 shops and extended its range to include nursery products, toys, themed bedroom accessories and a separate brand called Mini Marvellous that catered for children aged 2 to 8 years. Over a third of sales came directly via their website. In July 2010 the company was bought by Mothercare, which three years earlier had also acquired the Early Learning Centre.

Starting a business from home gives you a number of distinct advantages over those plumping for premises straight away. A study by the US Small Business Administration tracking the survival rates on new businesses (www.sba.gov/ADVO/research/business.html >Redefining Business Success) concluded that starting from home significantly improved a founder's chances of succeeding. Other studies coming from organisations less impartial suggest that home-based business are two thirds more likely to survive the crucial first four years of trading and so establish a firm footing.

Three big advantages that a home-based business has over its peers that give it an edge are:

- **Lower costs:** Starting from home saves most of the £35,000 start-up costs that the average business incurs even before it takes its first order. The chances are that you have nearly everything you need to start up your business already somewhere around your home. The kitchen table worked fine for Blooming Marvellous (see the nearby sidebar) to make their plans, pack up their first orders and do their accounts from. You can press into service a garage, loft, spare bedroom or garden shed for a whole host of business-related tasks from holding stock to being a dedicated office space away from the normal hustle of home life. Your computer, however old, will almost definitely work just fine, unless you're starting a business at the cutting edge of design or on the Internet.
- More time: Money can buy lots of things, but time isn't one of them. However close to your business premises you are, you'll spend an hour or more a day travelling to and from it. I'm sure if your shop, restaurant or office is only a couple of miles away you won't believe that proposition. How on earth could it be possible to take an

hour to travel just a mile? Well, an immutable law says that the closer your home is to your business premises, the more often you travel between the two. Ergo, if you're 20 miles away you go once a day, covering 40 miles, and if you're only 5 miles away you come home for lunch and return once or twice more each week to collect things you've forgotten. Whatever the distance, the average weekly travel time is about the same. Working from home gives you back all that wasted time spent travelling and you can invest the time in your business.

- **Less stress:** Commuting to work on a daily basis is stressful. In any vibrant and successful economic area road works, accidents, delays and traffic jams are pretty much the norm. Few people are fortunate enough to work in a car-free area or where parking is never a problem. Even if you could find such a paradise the chances are it would be useless as a business proposition. Depopulated areas are equally devoid of customers, suppliers and people to employ.

Finding the space

As a first step list all the activities involved in getting your business to the point where it has something to sell. If you're going to run a bookkeeping service this could be quite a short list. You need a computer, some software and perhaps a leaflet setting out your prices and the range of services on offer. But if you're going to repair musical instruments, say, then you may need much more space including perhaps a workshop.

Clearly, if you live in a cul-de-sac at the end of a narrow lane surrounded by other houses you're unlikely to be allowed to manufacture using hazardous chemicals and have articulated vehicles delivering and collecting in the middle of the night. You also have to consider how your neighbours will be affected, even if you're legally allowed to operate your business.

> You don't, of course, have to carry out every activity related to your business yourself, nor do you have to do it all on your premises. If you think about it you'll see that no business does everything itself.

When you know how much space you need for business and what you'll be doing in that space you can start to scour your home and garden for space to convert to business use. The following sections outline some areas to consider – not an exhaustive list, but enough ideas to kick-start your thinking.

Using the garage

The most obvious discreet space that's separate from the house and likely to be free of family traffic is your garage (if you have one). You can move cars onto the drive or a neighbouring street, subject to your insurance company being happy with that arrangement. According to the RAC Foundation, although 71 per cent of motorists have a garage, only 41 per cent use it to park their car. Most people use it as storage for junk or are too lazy to open the garage doors.

The Garage Conversion Company has sample plans and information on any possible restrictions that may apply (www.garageconversion.com; go to Conversion Ideas and then Home Office).

Parking in the parking space

This area and any private drive could be used for a caravan-based office, although you need to keep in mind that visitors, suppliers and of course you and your family still need to get access to your home.

If you do think that a caravan is worth considering check out that your house deeds allow you because covenants were introduced into the title deeds of new properties from the 1960s onwards to prevent people keeping caravans at home. Even if you're legally allowed to keep a caravan at home you should consider any possible impact on your neighbours and discuss your plans with them. Caravans that could be used as a home office, though probably not as touring caravans, sell for upwards of £1,000.

Planting yourself in the garden

You can install a shed up to 4 square metres without planning consent under certain circumstances. The exact rules are a little complicated; for example the shed can't be bigger than 50 per cent of your garden, you can't erect one in a conservation area and your title deeds can't expressly prohibit you. Great Little Garden (www.greatlittlegarden.co.uk) and Leisure Buildings (www.leisurebuildings.com) both offer advice on planning issues and have sections on using garden sheds as home offices. Sheds that you could use for home office purposes sell at garden centres for £800 upwards.

A further alternative, if space allows, is to rent or buy a portable 'room'. Portakabin (www.portacabin.co.uk) and Foremans Relocatable Building Systems (www.foremansbuildings.co.uk) have selections of new and second-hand cabins for rent and sale.

Climbing into an attic

Converting an attic to usable space is likely to be an expensive option and something to consider later after your business is up and running: £10,000 is the entry level price including a ladder and a window; double that if you want to include a WC, plastered walls and a power supply.

You may not need planning permission but as with garden sheds the rules are complicated. Econoloft (www.econoloft.co.uk; go to FAQ and Will I Need Planning) and UK Loft Conversion (www.uk-loft-conversion.com; go to FAQ and Do I Need to Get Building Regulations and Planning Approval?) have information on the rules and much else besides.

Doubling up in the spare room

If you do have a spare or under-utilised room then your search for office space is probably over. It will have heat, light and power and may also be out of the way of general family traffic. If it's currently a bedroom you could get the best of both worlds by putting in a sofa bed and desk with locked drawers. In that way occasional guests can still use the room and you can have it for most of the time. Though far from ideal this can be a low cost option that you can implement quickly.

Options (www.optionsfit.com) provides guides and products for turning your spare room into an office.

Checking out the rules

Whatever business you plan to run from home and whether the space you use is inside or outside of your property you need to check out a number of important rules and regulations before you start up.

Planning consent and building regulations

The extent to which the use of your home and the land it stands on changes determines whether or not you need planning consent or to consider building regulations. You may need permission for any structural alterations, increase in traffic, noise, smells or anything such as operating unreasonable hours or any disturbance that could affect your neighbours.

You can find out informally from your local council before applying and the Communities and Local Government website (www.communities.gov.uk; go to Planning, Building and the Environment) has detailed information on all these matters. You can also get free answers to specific questions using UK Planning's Planning Doctor (www.ukplanning.com), a service supported by some 20 UK councils.

Guidelines for using space at home

Keep these factors in mind when deciding on an area of your home to work from:

- The room or area needs to be well lit, warm in winter and cool in summer.

- The space shouldn't be claustrophobic because you could be in it 12 hours a day.

- Somewhere you can close the door, shut your business off and get on with normal family life will be a great asset.

- Allow room for some modest expansion. Try to anticipate what your business might look like a year out and make sure the space you allocate can accommodate that. Moving is disruptive, time consuming and expensive.

- You'll need power, a telephone line and access to the Internet.

Looking at health, safety and hazards

If you'll be working with materials that are flammable, toxic, give off fumes or are corrosive you should check on the website of the Health and Safety Executive (www.hse.gov.uk/risk) where you'll find detailed guidance and advice on all aspects of safety at work.

Considering insurance

Your home insurance policy won't cover any business activity so you must inform your insurer what you plan to do from home. You can find out more about whether or not what you plan to do from home needs special insurance cover and where to find an insurance company on the Business Link website (www.businesslink.gov.uk; go to Health, Safety, Premises; Insurance; Insure Your Business and Assets – General Insurances; and then Business Insurance If You Work from Home).

Managing the mortgage

Unless you own fully the freehold your property some other party such as a mortgage lender, landlord or freeholder may need to give their permission for you to run a business from home. Even as a freeholder you could find that a covenant has been included into your title deeds to prevent you operating certain activities from your home.

Realising business rates

You currently pay council tax on your home, but after you start using part of it or your grounds for business purposes you could be liable to pay business rates on the part of the property you use for work. You can see some examples of how business rating is applied to home-based businesses on the Valuation Office Agency website (www.voa.gov.uk/council_tax/examples_working_from_home.htm). Some types of small business, particularly those in rural areas providing products or services of particular benefit to the community, are exempt from paying business rates, or pay at a reduced rate. Your local council will have details of such schemes.

Anticipating capital gains tax implications

Any increase in value of your main home is usually free of capital gains tax (CGT) when you sell. However, if you set aside a room or particular area solely for working in then you may be liable for CGT on that proportion of any gain. If you expect to use a large (over 10 per cent) part of your home for business, take professional advice from your accountant and check the HM Revenue and Customs website (www.hmrc.gov.uk/cgt) for more information on CGT and how to calculate any possible liability.

Tax rates and their methods of payment are always in a state of flux, more so since the government introduced emergency measures in 2010 to reduce the country's indebtedness.

Readying for refuse

If your business will create additional or different refuse from that of a normal domestic nature then you should check your local council's policy on collecting for businesses. Also check on NetRegs (www.netregs.gov.uk), the government website that provides free environmental guidance for small businesses in the UK, what your responsibilities are for disposing of waste and hazardous substances.

Keeping in with the neighbours

After you've satisfied yourself that you're complying with all the relevant rules and regulations you'd still be prudent to advise your immediate neighbours of your plans. They may be concerned when they see any unusual comings and goings from your home and a timely word sets their minds at rest. Talking with neighbours will be especially important if you're doing building work.

> TIP: The Central Office of Information service Directgov has some useful pointers on what might cause problems with neighbours and how to resolve such issues (www.direct.gov.uk; go to Home and Community, Your Neighbourhood Roads and Streets, and then Neighbour Disputes).

Dealing with the family

You might be inclined to slop around just because you're working at home. The dangers here are twofold:

- You'll give out the wrong signals to everyone around you. As far as they can see you're just 'at home' and as such available for more or less anything that they'd usually expect in a domestic environment.

- You may not feel as though you're at work yourself. The operative word here is *appropriate*. That doesn't have to mean a suit and tie, but 'smart casual' is a good yardstick and certainly a notch up from what you wear around the house normally, say at weekends.

Dress is a powerful way of sending signals to those around you that you're 'at work'. Here are some other tools to help harmonise business and personal life while you work.

Negotiating with your partner

Your spouse, partner or housemate, whether or not he has a part to play in your business, will be affected and expect to be consulted on how you plan to make use of what he probably sees as his premises. The effect is double if he's picking up the financial slack until your business gets going. These measures help keep them your loved one onside:

- Tell him about your business ideas early on and why you think you'll succeed without disrupting home life unreasonably.
- Discuss the space you need, why you need it and if necessary 'trade' space. If you have to have one of the bedrooms, see what can you offer as compensation. In one rather dramatic case a boat builder needed all of the downstairs rooms for 12 months to build a prototype. The boat builder agreed to build a patio and conservatory the year his first boat sold.
- See whether you can provide a 'quick win' for everyone in your home. For example, if you need broadband Internet offer access to everyone either by setting time

aside on your computer or by providing another wireless enabled computer. Or if you're painting and redecorating your office, get other rooms done too.

- Explain the upside potential of what success will mean for everyone in your family when your business gets established: more money; part-time employment for those who want it; and eventually perhaps, a move to business premises.

Handling children

One of the advantages of starting your business from home is that you can adopt a great work–life balance from the outset. You can take the kids to school, be home when they get back, share meals with them and handle emergency trips to doctors and dentist yourself, rather than having to call in favours from relatives and friends. Few working more conventionally out of an office an hour or more's commute away can look after family matters with such relative ease.

Pre-school children who are going to be at home when you need to work are a different matter altogether. Sometimes they're asleep or resting and you're free to work at will. Otherwise you have two options. The simplest is to have a nanny to cover your peak working hours. Make sure the nanny knows you're working and find somewhere in the house where any noise won't disturb you. Alternatively, find a childminder or nursery nearby.

Vanquishing visitors

You may live in an area besieged by door-to-door salespeople, over-friendly neighbours who now know you're working from home or politicians after your vote. You can be certain than no one will be calling uninvited to discus business. Dealing with an unwanted visitor may only take a couple of minutes, but the interruption to your work flow may add as much as 20 minutes to that wasted time. Three visitors a week and you've lost an hour's output, mounting up to nearly seven man days over the year. That's probably equivalent to half the amount of holiday you'll be able to take in your first year or so in business, so you need to find a way to isolate yourself from such distractions.

Assessing Yourself

Business isn't just about ideas and market opportunities. Business is about people too, and at the outset it's mostly about *you*. You need to make sure that you have the temperament to run your own business and the expertise and understanding required for the type of business you have in mind.

The test at the end of this section requires no revision or preparation. You may find out the truth about yourself and whether or not running a business is a great career option or a potential disaster for you.

Discovering your entrepreneurial attributes

Business founders are frequently characterised as people who are bursting with new ideas, highly enthusiastic, hyperactive and insatiably curious. But the more you try to create a clear picture of the typical small business founder, the fuzzier that picture becomes. In reality, the most reliable indicator that a person is likely to start a business is that he has a parent or sibling who runs a business – such people are highly likely to start businesses themselves.

That being said, commentators generally accept some fairly broad characteristics as desirable, if not mandatory. Check whether you recognise yourself in the following list of entrepreneurial traits.

- **Accepting of uncertainty:** An essential characteristic of someone starting a business is a willingness to make decisions and to take risks. This doesn't mean gambling on hunches. It means carefully calculating the odds and deciding which risks to take and when to take them.

  Managers in big business tend to seek to minimise risk by delaying decisions until they know every possible fact. They feel that working with out all the facts isn't prudent or desirable. Entrepreneurs, on the other hand, know that by the time the fog of uncertainty has completely lifted, too many people are able to spot the opportunity clearly. In fact, an entrepreneur is usually only interested in decisions that involve accepting a degree of uncertainty.

- **Driven to succeed:** Business founders need to be results oriented. Successful people set themselves goals and get pleasure out of trying to achieve them as quickly as possible and then move on to the next goal. This restlessness is very characteristic.

- **Hardworking:** Don't confuse hard work with long hours. At times an owner-manager has to put in 18-hour days, but that shouldn't be the norm. Even if you do work long hours, as long as you enjoy them, that's fine. Enthusiasts can be very productive. Workaholics, on the other hand, have a negative, addictive, driven quality where outputs (results) are less important than inputs. This type of hard work is counterproductive. Real hard work means sticking at a task, however difficult, until you complete it. It means hitting deadlines even when you're dead-beat. It means doing some things you don't much enjoy so you can work your way through to the activities that you enjoy most.

- **Healthy:** Apart from being able to put in long days, successful small business owners need to be on the spot to manage the firm every day. Owners are the essential lubricant that keeps the wheels of small business turning. They have to plug any gaps when other people are ill or because they can't afford to employ anyone else for that particular job. They can't afford the luxury of sick leave. Even a week or so's holiday is something of a luxury in the early years of a business's life.

- **Innovative:** Most people recognise innovation as the most distinctive trait of business founders. They tend to tackle the unknown; they do things in new and difficult ways; they weave old ideas into new patterns. But they go beyond innovation itself and carry their concept to market rather than remain in an ivory tower.

- **Self-disciplined:** Owner-managers need strong personal discipline to keep themselves and the business on the schedule the plan calls for. This is the drumbeat that sets the timing for everything in the company. Get that wrong and you send incorrect signals to every part of the business, both inside and out.

  One of the most common pitfalls for novice businesspeople is failing to recognise the difference between cash and profit. Cash can make people feel wealthy and if it results in a relaxed attitude to corporate status symbols such as cars and luxury office fittings, then failure is just around the corner.

- **Totally committed:** You must have complete faith in your business idea. That's the only way in which you can convince all the doubters you're bound to meet along the route. But blind faith isn't enough. You have to back your commitment up with a sound business strategy.

- **Well rounded:** Small business founders are rarely geniuses. Some people in their business nearly always have more competence in one field than they could ever aspire to. But the founders have a wide range of ability and a willingness to turn their hand to anything that has to be done to make the venture succeed. They can usually make the product, market it and count the money, but above all they have the self-confidence that lets them move comfortably through uncharted waters.

Working out a business idea that's right for you

Take some time to do a simple exercise that can help you decide what type of business is a good match with your abilities. Take a sheet of paper and draw up two columns. In the left-hand column, list all your hobbies, interests and skills. In the right-hand column, translate those interests into possible business ideas. Table 3-1 shows an example of such a list.

Table 3-1 Matching a Business Idea to Your Skills

Interest/Skills	*Business Ideas*
Cars	Car dealer; repair garage; home tuning service; valet and cleaning/taxi
Cooking	Restaurant; home catering service; providing produce for home freezers
Gardening	Supplying produce to flower or vegetable shops; running a nursery; running a garden centre; landscape design; running a gardening service
Using a computer	Typing authors' manuscripts from home; typing back-up service for busy local companies; running a secretarial agency; web design; bookkeeping service; selling online

Having done this exercise, balance the possibilities against the criteria that are important to you in starting a business.

Figuring out what you're willing to invest

I'm not just talking about money here. How much are you willing to invest of your time, your interest and your education, as well as your (and your investors') money?

Spending time

How much time are you willing to devote to your business? That may sound a basic enough question, but different businesses done in different ways can have quite different time profiles. One business starter I know started a French bakery in London. He was determined to make his own croissants and did so for the first three months. But making his own bread meant starting work at 4 a.m. Because he didn't close until city workers passed his door on their way home, by the time he cleaned up and took stock, he was working a 15-hour day. But he still had the books to do, orders to place and plans to prepare. He eventually settled for a 10-hour day, which meant that he had to buy in ready-baked croissants.

Furthering your education

You may have identified a market opportunity that requires skills over and above those that you currently have. There may, for example, be a gap in the market for Teaching English as a Foreign Language (TEFL), but to do so requires a month of intensive study plus a £1,000 course fee. Doing the TEFL certificate may involve you in more skill upgrading than you want to commit to, at the outset at least. So either you need to find customers who don't require you to have that qualification, or you need to think about a less educationally challenging business.

Keeping things interesting

If you want to start a restaurant and have never worked in catering, get a job in one. That's the best way to find out whether you like a particular type of work. You may find that a restaurant looks very different from behind the chair as opposed to on it. Some businesses are inherently repetitive, with activities that follow a predictable pattern. If that suits you, fine, but if not then perhaps you need to consider a business venture with a shifting range of tasks.

Weighting your preferences

After you have an idea of some of the businesses you may want to start, you can rank those businesses according to how closely they match what you want from starting a business. Go through the standards you want your business to meet and assign a weight between 1 and 5 to each, on a range from not important at all to absolutely must have. Next, list your possible business opportunities and measure them against the graded criteria.

Table 3-2 shows a sample ranking for Jane Clark, an imaginary ex-secretary with school-aged children who needs work because her husband has been made redundant and is looking for another job. Jane isn't in a position to raise much capital, and she wants her working hours to coincide her children's school day. She wants to run her own show and she wants to enjoy what she does.

Table 3-2 Weighing Up the Factors

Criteria	*Weighting Factor*
Minimal capital required	5
Possibility to work hours that suit lifestyle	5
No need to learn new skills	4
Minimal paperwork	3
Work satisfaction	2
Opportunity to meet interesting people	1

Because minimal capital was an important criterion for Jane she gave it a weight of 5, whereas meeting interesting people, being less important to her, was only weighted 1. Jane gave each of her three business ideas a rating, in points (out of five) against these criteria. A secretarial agency needed capital to start so she gave it only 1 point. Back-up typing needed hardly any money and she allocated 5 points to it. Her worked-out chart is shown in Table 3-3.

Table 3-3 Scoring Alternatives

		Secretarial Agency		*Back-up Typing*		*Authors' Manuscripts*	
	Weighting Factor	***Points***	***Score***	***Points***	***Score***	***Points***	***Score***
Criteria							
Minimal capital	5 ×	1	5	5	25	4	20
Flexible hours	5 ×	1	5	3	15	5	25
No new skills	4 ×	2	8	5	20	5	20
Work satisfac-tion	3 ×	4	12	1	3	3	9
Minimal paper-work	2 ×	0	0	4	8	5	10
Meeting people	1 ×	4	4	3	3	4	4
Total score			34		74		88

The weighting factor and the rating point multiplied together give a score for each business idea. The highest score indicates the business that best meets Jane's criteria. In this case, typing authors' manuscripts scored over back-up typing, because Jane could do it exactly when it suited her.

Chapter 4

Testing Feasibility

In This Chapter

- Making sure you can find the product and the people
- Doing market research
- Checking out business viability
- Seeing whether you can make a profit

You need to decide whether or not starting up your own business is for you. Maybe you've reached a tentative decision on whether to go it alone or to join forces with others who have valuable resources or ideas to add to your own, and now have the bones of an idea of what type of business you want to start, buy into, franchise or enter in some other way.

So all you have to do now is wait for the customers to turn up and the cash to roll in. Right? Wrong, regrettably. Although you're beyond square one, you have a good few miles to cover before you can be confident that your big business idea is actually going to work and make money. This chapter gives you the right questions to ask to make you as sure as you can be that you have the best shot at success.

Finding Enough Product or People

The first test of feasibility is whether you can get enough goods to sell or enough people to provide the service you're offering. You need to be sure that you can get your product manufactured at the rate and quantity to meet your needs. Likewise, if you're starting a service business, you need to be sure that you can hire people with the skills you need, whether they're housecleaners or web page designers.

Of course, if you're buying into a franchise or joining an existing business or co-operative, these issues are already addressed for the most part. Still, it never hurts to do your own assessment of the *supply chain* linking you to your source of materials and onwards to your end customers, if only to familiarise yourself with the process.

How much is enough?

The amount of goods or services you need depends in part on the scale of your ambitions and also on what you believe the market can bear. If the area in which you plan to open a restaurant has a total population of 100 people within a 50-mile radius, that fact alone limits the scale of your venture.

It makes sense to work backwards to answer this question. For example, if you want to make at least as much money from your business as you have in wages from your current job, then you can use that figure to work out the initial scale of your level of output. As a rough rule of thumb, if you want to make £10,000 profit before tax, a business involved in manufacturing or processing materials needs to generate between £80,000 and £100,000 worth of orders. Taking away your anticipated profit from the sales target leaves you with the value of the goods and services you need to buy in.

Buying in equipment and supplies

There are four main areas to check out:

- **Consumable materials:** If you're making things yourself, you need to check out suppliers of raw materials. Even if, like mail-order firms, you're buying in finished product, you should check that out too. You can search on Google, Yahoo!, Bing, Ask Jeeves or any of the major search engines for almost any product or service. However, unless the quantities are large and significantly better terms can be had elsewhere, you're better sticking to local suppliers for consumables. This is an inexpensive way to build up goodwill in the local community and may even create business for you. See *Kellysearch* and *Kompass* directories for details of suppliers of consumables (see the next bullet for details).
- **Equipment:** If you're going to make any or all of your products yourself, you need to check out suppliers, delivery times, payment terms and so forth for the equipment you need for the production processes. You first need to check out the output levels and quality standards of any equipment you want, to make sure it meets your needs. You can find equipment suppliers in either *Kellysearch* (www.kellysearch.co.uk) or *Kompass* (www.kompass.com). These two directories between them contain information on 23 million products and services from 2.7 million suppliers in over 70 countries. These directories are available both in your local business library and, to a limited extent, online.
- **Finished goods:** It's usually a better use of scarce cash for a new business to buy in product that's as close to its finished state as possible, leaving you only the high-value-added tasks to complete. Few niche mail-order catalogue businesses make any of their own product;

their key skills lie in merchandise selection, advertising copy, web design or buying in the right mailing lists. *Kellysearch* and *Kompass* directories list almost every finished goods supplier.

- **Premises:** Finding the right premises can be the limiting factor for some businesses. If, for example, you need to be in a particular type of area, as with restaurants, coffee shops and night clubs, it could take months for the right place to come on the market and even longer to get planning or change-of-use consent if you require that. When you have a clear idea of the type of premises you want, check out all the commercial estate agents in the area. It makes sense to have a few alternative locations in your plans too.

Hiring in help

Unless you plan to do everything yourself on day one, you need to confirm that people with the skills you need are available in your area at wage rates you can afford. Start by looking in the situations vacant section of your local newspaper under the appropriate headings. If you need kitchen staff for your new restaurant and the paper has 20 pages of advertisers desperately looking for staff, then you may well have a problem on your hands. Chapter 11 looks at finding employees for your business.

Sizing Up the Market

You need to ensure that enough customers, with sufficient money to spend, exist to create a viable marketplace for your products or services. You must also see who's competing against you for their business. In other words, you need to research your market.

Market research is something that potential financial backers – be they banks or other institutions – insist on. And in this they're doing you a favour. Many businesses started with private money fail because the founders don't thoroughly research the market at the outset.

Whatever your business idea, you must undertake some well-thought-out market research before you invest any money or approach anyone else to invest in your venture.

Market research has three main purposes:

- **To build credibility for your business idea:** You must prove, first to your own satisfaction and later to outside financiers, that you thoroughly understand the marketplace for your product or service. This proof is vital to attracting resources to build the new venture.
- **To develop a realistic market entry strategy:** A successful marketing strategy is based on a clear understanding of genuine customer needs and on the assurance that product quality, price and promotional and distribution methods are mutually supportive and clearly focused on target customers.
- **To gain understanding of the total market, both customers and competition:** You need sufficient information on your potential customers, competitors and market to ensure that your market strategy is at least on the target, if not on the bull's-eye itself. If you miss the target altogether, which you may well do without research, you may not have the necessary cash resources for a second shot.

The military motto ‘Time spent in reconnaissance is rarely time wasted’ holds true for business as well.

Before you start your research:

1. **Define your objectives.**

   Figure out what you absolutely have to know. For example, how often do people buy whatever it is you’re selling and how much?

2. **Identify the customers to sample for this information.**

   Decide who you want to sample and how you can best reach them. For example, for do-it-yourself products, an Ideal Home Exhibition crowd might be best.

3. **Decide how best to undertake the research.**

   Choose the research method best suited to getting the results you need. For example, face-to-face interviews in the street may allow you direct access to potential customers.

4. **Think about how you can analyse the data.**

   If your research involves complex multi-choice questions or a large sample size, you may need to plan in advance to use a computer and the appropriate software to help you process the data, which in turn means coding the questions. An even better idea is to keep it so simple you don’t need a computer!

You can analyse the raw market research data and turn it into information to guide your decisions on price, promotion, location and the shape, design and scope of the product or service itself.

The following sections cover the areas you need to consider to make sure you’ve properly sized up your business sector.

Figuring out what you need to know

Before embarking on your market research, set clear and precise objectives. You don't want just to find out interesting information about the market in general, and you don't want to spend time and money exploring the whole market when your target is merely a segment of that market. (I talk about segmenting the market in the 'Finding your segment of the market' section coming up in a bit.)

You have to figure out who your target customer is and what you need to know about him or her. For example, if you're planning to open a shop selling to young, fashion-conscious women, your research objective may be to find out how many women between the ages of 18 and 28, who make at least £25,000 per annum, live or work within two miles of your chosen shop position. That gives you some idea of whether the market can support a venture such as yours.

You also want to know what the existing market is for your product and how much money your potential customers spend on similar products. You can get a measure of such spending from Mintel reports (www.mintel.com). Mintel publishes over 400 reports every year covering key sectors such as fast-moving consumer goods (FMCG), financial services, media, retail, leisure and education. Worldwide office locations include London, Chicago, New York, Shanghai, Tokyo and Sydney.

Figuring out the size of the market may require several different pieces of information. You may want to know the resident population of a given area, which may be fairly easy to find out, and also something about the type of people who come into your area for work, for leisure, on holiday or for any other purpose. A nearby hospital, library, railway station or school, for example, may pull potential customers into your particular area.

You also want to know as much as you can about your competitors – their share of the market, their marketing strategy, their customer profile, product pricing schemes and so on.

You need to research in particular:

- **Your customers:** Who's going to buy your goods and services? What particular customer needs does your business meet? How many of them are there, are their numbers growing or contracting, how much do they spend and how often do they buy?
- **Your competitors:** Which established businesses are already meeting the needs of your potential customers? What are their strengths and weaknesses? Are they currently failing their customers in some way that you can improve on?
- **Your product or service:** Can, or should, it be tailored to meet the needs of particular groups of customers? For example, if you're starting up a delivery business, professional clients may require a same-day service, but members of the public at large may be happy to get goods in a day or two, provided this is less costly.
- **The price you should charge:** All too often small firms confine their research on pricing to seeing what the competition charges and either matching it or beating it. That may be a way to get business, but it's not the best route to profitable business. You need to know what price is perceived as being too cheap, what represents good value for money and what's seen as a rip-off, so you can pitch in at the right price for your offering.

- **Which promotional material will reach your customers:** What newspapers and journals do they read and which of these is most likely to influence their buying decision?
- **Your location:** From where can you reach your customers most easily and at minimum cost?
- **Most effective sales method:** Can you use telesales, the Internet or a catalogue, or do customers only buy face to face either from a salesperson or from a retail outlet?

Research isn't just essential in starting a business but should become an integral part in the ongoing life of the business. Customers and competitors change; products and services don't last forever. When started, however, ongoing market research becomes easier, because you have existing customers (and staff) to question. Make sure you regularly monitor their views on your business (as the sign in the barber shop stated: 'We need your head to run our business') and develop simple techniques for this purpose (for example, questionnaires for customers beside the till, or suggestion boxes with rewards for employees).

Finding your segment of the market

Market segmentation is the process whereby you organise customers and potential customers into clusters of similar types, such as age, sex, education level or location.

The starting point for your business may be to sell clothes, but 'every person who buys clothes' is too large and diverse a market to get a handle on. So you divide that market into different segments – clothes for men, women and children, for example – and then further divide those segments into clothes for work, leisure, sports and social occasions. You just segmented your market.

Taking the segmentation process a stage further could involve dividing the market by age group, income, geography or social group, such as yuppie (young, upwardly mobile, professional), Bumps (borrowed-to-the-hilt upwardly mobile professional show-off) and Jollies (jet-setting oldies with lots of loot). There are no hard and fast rules on how to segment markets. If any particular group of people have different needs or expectations of a product or service hey presto you have a new segment.

Above all, customers increasingly want products and services tailored to their needs and are prepared to pay for the privilege.

Use the following guidelines to help determine whether a market segment is worth trying to sell into:

- **Accessibility:** Can you communicate with these customers, preferably in a way that reaches them alone? For example, you can reach the over-50s through advertising in a specialist magazine, with reasonable confidence that young people don't read it. So if you're trying to promote a large-print edition of a game, you may prefer that young people don't hear about it, so that they don't think of the game as strictly for old folks.
- **Measurability:** Can you estimate how many customers are in the segment? Are there enough to make it worth offering something different for?
- **Open to profitable development:** The customers must have money to spend on the benefits you propose offering. Once upon a time oldies were poor, so they weren't good targets for up-market, expensive products.

Then they became rich and everyone had products aimed at older markets.

Budgeting for your research

Market research isn't free even if you do it yourself. At the very least, you have to consider your time. You may also spend money on journals, phone calls, letters and field visits. And if you employ a professional market research firm, your budgeting needs shoot to the top of the scale.

For example, a survey of 200 executives responsible for office equipment purchasing decisions cost one company £12,000. In-depth interviews with 20 banking consumers cost £8,000.

Doing the research in-house may save costs but limit the objectivity of the research. If time is your most valuable commodity, it may make sense to get an outside agency to do the work. Another argument for getting professional research is that it may carry more clout with investors.

Whatever the cost of research, you need to assess its value to you when you're setting your budget. So if getting it wrong will cost £100,000, then £5,000 spent on market research may be a good investment.

Doing the preliminary research

Research methods range from doing it all from your desk to getting out in the field yourself and asking questions – or hiring someone to do it for you. The following sections explore the various methods you can use to find out what you need to know.

Doing research behind your desk

When you know the questions you want answers to, the next step is finding out whether someone else has the answers already. Much of the information you need may well be published, so you can do at least some of your market research in a comfortable chair either in your home or in a good library. Even if you use other research methods, it's well worth doing a little desk research first.

Gathering information at the library

Thousands of libraries in the UK and tens of thousands elsewhere in the world between them contain more desk research data than any entrepreneur ever requires. Libraries offer any number of excellent information sources. You can either take yourself to your local library or bring the library's information to you via the Internet if you're dealing with one of the reference libraries in a larger city or town.

As well as the fairly conventional business books, libraries contain many hundreds of reference and research databases. For example, the official Census of Population supplies demographic data on size, age and sex of the local populace. You can also find a wealth of governmental and other statistics that enable you to work out the size and shape of the market nationwide and how much each person spends.

You can find details of every journal, paper and magazine's readership in *BRAD* (British Rate and Data) and every company has to file details of its profits, assets, liabilities and directors at Companies House, the place where all business details and accounts are kept (www.companieshouse.org.uk). Their WebCHeck service offers a free-of-charge, searchable Company Names and Address Index that covers 2 million companies either by name or unique company registration number.Some market information data costs hundreds of pounds and some is available only to subscribers who pay thousands of pounds to have it on tap. Fortunately for you, your library (or an Internet link to a library) may have the relevant directory, publication or research study on its shelves.

Librarians are trained, amongst other skills, to archive and retrieve information and data from their own libraries and increasingly from Internet data sources as well. Thus, they represent an invaluable resource that you should tap into early in the research process. You can benefit many times from their knowledge at no cost, or you may want to make use of the research service some libraries offer to business users at fairly modest rates.

Apart from public libraries, you can access hundreds of university libraries, specialist science and technology libraries, and government collections of data with little difficulty.

Using the power of the Internet

The Internet can be a powerful research tool. However, it has some particular strengths and weaknesses that you need to keep in mind when using it.

Strengths of the Internet include:

- Offers cheap access and often free information
- Provides good background information
- Produces information quickly
- Covers a wide geographic scope

Weaknesses of the Internet include:

- The bias is strongly towards the US
- Coverage of any given subject may be patchy
- Authority and credentials are often lacking

It would be a brave or foolhardy entrepreneur who started up in business or set out to launch new products or services without at least spending a day or two surfing the Internet. At the very least this lets you know whether anyone else has taken your business idea to market. At best, it may save you lots of legwork around libraries, if the information you want is available online.

You can gather market research information on the Internet in two main ways:

- Use directories, search engines or telephone directories to research your market or product.
- Use blogs, bulletin or message boards, newsgroups and chat rooms to elicit the data you require.

These two useful search portals can help get you started:

- Business.com (www.business.com)
- Easy Searcher 2 (www.easysearcher.com)

These are some of the most useful online sources of information on markets:

- **Corporate Information** (www.corporateinformation.com; go to Tools and then Research Links) is a business information site covering the main world economies, offering plenty of free information. This link takes you to sources of business information in over 100 countries.

- **Doing Business** (www.doingbusiness.org): This is the World Bank's database that provides objective measures of business regulations across 183 countries and produces occasional reports on major cities within those countries. You can find out everything from the rules on opening and closing a business to trading across borders, tax rates, employment laws, enforcing contracts and much more. The site also has a tool for comparing countries to rank them by the criteria you consider most important.
- **MarketResearch.com** (www.marketresearch.com) claims with some justification to be the world's largest continuously updated online collection of market research, offering over 250,000 market research reports from over 650 leading global publishers. Whether you're looking for new product trends or competitive analysis of a new or existing market, alerts from this source will keep you on top of the latest available intelligence.
- **NationMaster.com** (www.nationmaster.com): This provides a compilation of data from such sources as the *CIA World Factbook*, the United Nations and the Organisation for Economic Co-operation and Development. Using the tools on the website you can generate maps and graphs on all kinds of statistics with ease. Their aim is to be the web's one-stop resource for country statistics on everything.
- **Trade Association Forum** (www.taforum.org; go to Directories and then Association Directory) is the online directory of trade associations on whose websites are links to industry-relevant online research sources. For example, you can find the Baby Products Association

listed, at whose website you can find details of the 238 companies operating in the sector with their contact details.

- **Warc** (www.warc.com) claims to provide the most comprehensive marketing information service in the world. Their online guide to world advertising trends is based on latest annual advertising expenditure data across all main media for more than 60 countries, outlining key trends in media investment over the last ten years.

Getting to the grass roots

If the market information you need isn't already available, and the chances are that it isn't, then you need to find the answers yourself.

Going out into the marketplace to do market research is known as *field research*, or sometimes *primary research*, by marketing professionals.

Field research allows you to gather information directly related to your venture and to fine-tune results you get from other sources. For example, entrepreneurs interested in opening a classical music shop in Exeter aimed at young people were encouraged when desk research showed that of a total population of 250,000, 25 per cent were under 30. However, the research didn't tell them what percentage of this 25 per cent was interested in classical music nor how much money each potential customer might spend. Field research showed that 1 per cent was interested in classical music and would spend £2 a week, suggesting a potential market of only £65,000 a year (250,000 × 25% × 1% × £2 × 52)! The entrepreneurs sensibly decided to investigate Birmingham and London instead. But at least the cost had been only two damp afternoons spent in Exeter, rather than the horror of having to dispose of a lease on an unsuccessful shop.

Most field research consists of an interviewer putting questions to a respondent. No doubt you've become accustomed to being interviewed while travelling or resisting the attempts of an enthusiastic salesperson on your doorstep posing as a market researcher (*slugging*, as this is known, has been illegal since 1986).

The more popular forms of interviews are:

- Personal (face-to-face) interview (especially for consumer markets)
- Telephone (especially for surveying businesses)
- Postal survey (especially for industrial markets)
- Test and discussion groups
- Internet surveys

Personal interviews and postal surveys are clearly less expensive than getting together panels of interested parties or using expensive telephone time. Telephone interviewing requires a very positive attitude, courtesy, an ability not to talk too quickly and listening while sticking to a rigid questionnaire. Low response rates on postal surveys (normally less than 10 per cent) can be improved by including a letter explaining the purpose of the survey and why respondents should reply; by offering rewards for completed questionnaires (a small gift); by associating the survey with a charity donation based on the number of respondents; by sending reminder letters; and, of course, by providing pre-paid reply envelopes.

Internet surveys using questionnaires similar to those conducted by post or on the telephone are growing in popularity. On the plus side, the other survey methods involve having the data entered or transcribed at your expense, but with an Internet survey the respondent enters the data. Internet survey software also comes with the means of readily analysing the data, turning it into useful tables and charts. Such software may also have a statistical package to check out the validity of the data itself and so give you some idea how much reliance to place on it.

Buying the software to carry out Internet surveys may be expensive, but you can rent it and pay per respondent for each survey you do.

Check out companies such as Free Online Surveys (http://free-online-surveys.co.uk) and Zoomerang (www.zoomerang.com) that provide software that lets you carry out online surveys and analyse the data quickly. Most of these organisations offer free trials – Free Online Surveys, for example, allows you to create a survey of up to 20 questions and receive up to 50 responses over a ten-day period, beginning when you start creating your survey. An upgrade to their SurveyExtra lets you ask as many questions as you want with up to 1,000 responses for $19.95 per month.

Once upon a time samples of Internet users were heavily biased towards students, big companies and university academics. Not any more. In 2010, according to the Office for National Statistics, 30.1 million adults in the UK (60 per cent) accessed the Internet every day or almost every day. This is nearly double the estimate in 2006 of 16.5 million. This means you can canvas almost everyone’s views.

Conducting the research

Field research means that you have to do the work yourself: decide the questions, select the right people to ask those questions and then interpret the data when you have it. This is completely different from desk research, where all that work has been done for you. But field research can be worth every ounce of sweat that goes into it. You get information that no one else is likely to have at their finger tips, and knowledge in the business start-up arena is definitely power. When you come to writing up your business plan (see Chapter 6) you'll have the evidence to support your belief in your business.

Setting up a sample

It's rarely possible or even desirable to include every potential customer or competitor in your research. Imagine trying to talk to all pet owners before launching Petfeed.com! Instead you select a sample group to represent the whole population.

Sampling saves time and money and can be more accurate than surveying an entire population. Talking to every pet owner may take months. By the time you complete your survey, the first people questioned may have changed their opinions, or the whole environment may have changed in some way.

You need to take care and ensure that you've included all the important customer segments you've targeted as potential users or buyers of your products or services in your research sample.

The main sampling issue is how big a sample you need to give you a reliable indication of how the whole population behaves. The accuracy of your survey increases with the sample size, as Table 4-1 shows. There you'll see that a sample of 250 is generally (95 per cent of the time) accurate only to between plus 6.2 per cent to minus 6.2 per cent. This means that 12.4 per cent of the time it will generally be above or below the true figure. Up the sample to 6,000 and the error range drops to between plus 1.2 per cent and minus 1.2 per cent, a range of just 2.4 per cent. You need to ensure that each of your main customer segments – for example, the over-50s, people earning between £20,000 and £30,000 a year or those without university degrees, if those are groups of people whose views are important to your strategy – are included in the sample in numbers sufficient to make your sample reasonably reliable.

Table 4-1 Sample Size and Accuracy

Number in Sample	*Percentage Accuracy of 95% of Surveys*
250	Accurate to a range of + to – 6.2% of true figure
500	Accurate to a range of + to – 4.4% of true figure
750	Accurate to a range of + to – 3.6% of true figure
1,000	Accurate to a range of + to – 3.1% of true figure
2,000	Accurate to a range of + to – 2.2% of true figure
6,000	Accurate to a range of + to – 1.2% of true figure

For most basic research a small business may find the lower sample sizes accurate enough, given the uncertainty surrounding the whole area of entering new markets and launching new products.

Asking the right questions

To make your field research pay off you have to ask the questions whose responses tell you what you need to know. Writing those questions is both an art and a science – both aspects of which you can master by using the following tips:

- Keep the number of questions to a minimum. A dozen or so should be enough – 25 is getting ridiculous.
- Keep the questions simple. Answers should be either Yes/No/Don’t Know or somewhere on a scale such as

Never/Once a Month/Three or Four Times a Month/Always.

- Avoid ambiguity. Make sure the respondent really understands the question by avoiding vague words such as *generally*, *usually* and *regularly*. Seek factual answers; avoid opinions.
- Make sure you have a cut-out question at the beginning to eliminate unsuitable respondents. You don't want to waste time questioning people who never use your kind of product or service.
- Put an identifying question at the end so that you can make sure you get a suitable cross-section of respondents. For example, you may want to identify men from women, people living alone from those with children or certain age groups.

The introduction to a face-to-face interview is important. Make sure you're prepared, either carrying an identifying card (maybe a student card or watchdog card) or with a rehearsed introduction (such as 'Good morning, I'm from Cranfield University [show card] and we're conducting a survey and would be grateful for your help'). You may also need visuals of the product you're investigating (samples, photographs) to ensure that the respondent understands. Make sure these are neat and accessible.

Try out the questionnaire and your technique on your friends prior to using them in the street. You may be surprised to find that questions that seem simple to you are incomprehensible at first to respondents!

Remember, above all, that questioning is by no means the only or most important form of fieldwork. Another form of fieldwork market research you should undertake is to get out and look at your competitors' premises, get their catalogues and price lists, go to exhibitions and trade fairs relevant to your chosen business sector and get information on competitors' accounts and financial data. One would-be business starter found out from the company's accounts, obtained from Companies House (www.companieshouse.org.uk), that the 'small' competitor near to where he planned to locate was in fact owned by a giant public company that was testing out the market prior to a major launch itself.

All methods can be equally valid depending only on the type of market data you need to gather. The results of each piece of market research should be carefully recorded for subsequent use in presentations and business plans.

After the primary market research (desk and field research) and market testing (stalls and exhibitions) are complete, if you're investing a substantial amount of money up front in your venture, then you should pilot test the business in one location or customer segment before launching fully into business. Only then can you make a reasonably accurate prediction of sales and the cash-flow implications for your business.

Finding test subjects

Now you need someone to ask your questions of. If you're doing a street survey, you have to make do with whoever comes along. Otherwise, to carry out a survey your best bet is to buy or rent a mailing list. Typically, you pay a fee to the list owner, such as a magazine with its list of subscribers. You negotiate a fee for how many times you're allowed to use the list. Note that you aren't the owner of the list.

Several individual freelancers specialise in brokering lists and building lists. You may want to consider hiring an individual for a consultation or to manage the entire process. Marketing professionals claim that buying lists is a science, but you can master this science on your own, especially if you're trying to reach a local or regional market. Think of publications, organisations and businesses whose lists are most likely to contain people who may buy your product or service. Don't overlook trade magazines, regional magazines or non-competing businesses with a similar customer base. You can then select and narrow your lists by looking at nearly any demographic variable to arrive at as close to your description of your target market as possible. Listbroker (www.listbroker.com) and Electric Marketing (www.electricmarketing.co.uk) between them can provide lists of all types.

Working Out Whether You Can Make Money

There isn't much point in trying to get a new business off the ground if it's going to take more money than you can raise or take longer to reach break even and turn in a profit than you can possibly survive unaided. I look in more detail at financial matters such as profits and margins in Chapter 13, but you can't start looking at the figures soon enough. Doing some rough figures at the outset can save you a lot of time pursuing unrealistic or unprofitable business opportunities.

Estimating start-up costs

Setting up a business requires money – you can't get away from that. You have rent to pay, materials and equipment to purchase, and all before you receive any income. Starting a business on the road to success involves ensuring that you have sufficient money to survive until the point where income continually exceeds expenditure.

Raising this initial money and the subsequent financial management of the business are therefore vital, and you should take great care over these matters. Unfortunately, more businesses fail due to lack of sufficient day-to-day cash and financial management than for any other reason.

JARGON ALERT

The first big question is to establish how much money you need. Look at every possible cost and divide them into one-off, fixed or variable categories. The *fixed costs* are those that you have to pay even if you make no sales (rent, rates, possibly some staff costs, repayments on any loans and so on) as well as some *one-off costs*, or one-time purchases such as buying a vehicle or computer, which you won't repeat after the business is up and running. *Variable costs* are those that vary depending on the level of your sales (raw materials, production and distribution costs, and so on).

Your finance requirements are shown very clearly on your cash-flow forecast, which is a table showing, usually on a monthly basis, the amount of money actually received into the business, and the amount of money paid out.

According to the Bank of England's report on small business finance, the average start-up cost for a new business in the UK is just over £35,000. However, that average conceals some wide variations. Some start-ups, particularly those in technology or manufacturing, may require hundreds, thousands or even millions of pounds, but others, such as those run from home, may cost very little or nothing.

Six out of every ten people starting up a business use personal funds as their initial source of finance. Naturally, using your own money – your savings, your unmortgaged property, your life insurance and your other assets – is a logical starting point. You may not feel you can put all your worth behind a business because of the risks involved, but whichever route you go down you’re normally expected to invest some of your own assets. Banks seek personal guarantees, and venture capitalists like to see owners taking risks with their own money – why should they risk their clients’ money if you aren’t risking yours?

If you can fund the project from your own resources, doing so presents some attractions. Only in this way do all the rewards of success flow to you. As soon as you bring in other sources of finance those sources slice off some of the reward, be it interest, share of the value on the sale of the business or dividends. They may also constrain the business through the use of covenants, borrowing limits and placing financial obligations on the business – potentially not only carving off part of your rewards but also capping them by restricting your operation.

Forecasting sales

All forecasts may turn out to be wrong, but it’s important to demonstrate in your strategy that you’ve thought through the factors that affect performance. You should also show how you can deliver satisfactory results even when many of these factors work against you. You need this information to give you comfort, and both your backers and employees alike measure the downside risk to evaluate the worst scenario and its likely effects, and look towards an ultimate exit route.

Here are some guidelines to help you make an initial sales forecast:

- **Credible projections:** Your overall projections have to be believable. Most lenders and investors have extensive experience of similar business proposals. Unlike you, they have the benefit of hindsight, being able to look back several years at other ventures they've backed and see how they fared in practice as compared with their initial forecasts.

  You can gather some useful knowledge on similar businesses yourself by researching company records (at Companies House, www.companieshouse.gov.uk, where the accounts of most British companies are kept) or by talking with the founders of similar ventures who aren't your direct competitors.

- **Customers:** How many customers and potential customers do you know who are likely to buy from you, and how much might they buy? Here you can use many types of data on which to base reasonable sales projections. You can interview a sample of prospective customers, issue a press release or advertisement to gauge response and exhibit at trade shows to obtain customer reactions. If your product or service needs to be on an approved list before it can be bought, then your business plan should confirm that you have that approval, or less desirably, show how you can get it.

  You should also look at seasonal factors that may cause sales to be high or low at certain periods in the year. This is particularly significant for cash-flow projections. You should then relate your seasonal, customer-based forecast to your capacity to make or sell at this rate. Sometimes your inability to recruit or increase capacity may limit your sales forecasts.

- **Desired income:** This approach to estimating sales embraces the concept that forecasts may also accommodate the realistic aims of the proprietor. Indeed, you can go further and state that the whole purpose of strategy is to ensure that the business achieves certain forecasts. This is more likely to be the case in a mature company with proven products and markets than in a start-up.

Nevertheless, an element of 'How much do we need to earn?' must play a part in forecasting, if only to signal when a business idea isn't worth pursuing.

One extreme of the desired income approach to forecasting comes from those entrepreneurs who think that the forecasts are the business plan. Such people cover the business plan with a mass of largely unconnected numbers. With reams of computer printout covering every variation possible in business, complete with sensitivity analysis, these people are invariably a big turn-off with financiers.

- **Market guidelines:** Some businesses have accepted formulas you can use to estimate sales. This is particularly true in retailing, where location studies, traffic counts and population density are known factors.
- **Market share:** How big is the market for your product or service? Is it growing or contracting and at what rate, as a percentage per annum? What is the economic and competitive position? These are all factors that can provide a market share basis for your forecasts. An entry market share of more than a few per cent is most unusual. But beware of turning this argument on its head. Unsubstantiated statements such as 'In a market of £1 billion per annum we can easily capture 1 per cent, which is £1 million a year' impress no investor.

Exceeding break even

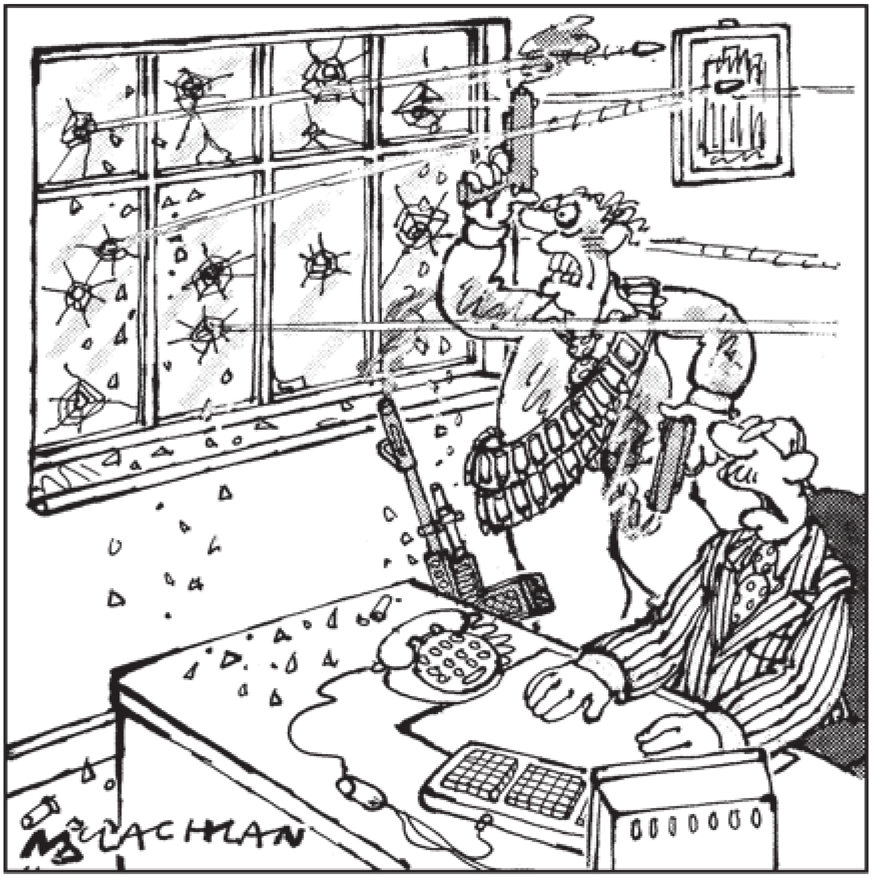
So far I've taken certain decisions for granted and ignored how to cost the product or service you're marketing, and indeed, how to set the selling price.

Your goal is to get past break even, the point at which you've covered all your costs, and into the realm of making profits as quickly as possible. So these decisions are clearly important if you want to be sure of making a profit.

At first glance the problem is simple. You just add up all the costs and charge a bit more. The more you charge above your costs, provided the customers keep on buying, the more profit you make. Unfortunately, as soon as you start to do the sums the problem gets a little more complex. For a start, not all costs have the same characteristics. Some costs, for example, don't change however much you sell. If you're running a shop, the rent and rates are relatively constant figures, completely independent of the volume of your sales. On the other hand, the cost of the products sold from the shop is completely dependent on volume. The more you sell, the more it costs you to buy in stock. You can't really add up those two types of costs until you've made an assumption about how much you plan to sell. You can find out more detail about this subject in Chapter 13.

Part II

Making and Funding Your Plan



'Look, Filligrew, this company has always insisted its employees leave their private lives at home.'

In this part . . .

Running your own business means constantly juggling resources. You need to focus on a product or service that you can provide better than or differently to those already in the market. This part helps you decide on the best way to develop and communicate your marketing strategy, set a selling price, decide on a place to operate from, and how and where to advertise.

Having customers means you have to produce product or deliver your service, which requires cash that you in turn will have to find. Before any financier will discuss your cash needs seriously you will need to put together your business plan.

Chapter 5

Structuring Your Business

In This Chapter

- Finding the right business form
- Exploring working on your own
- Going into partnership with others
- Starting a larger company
- Looking at legalities

When you start your business you have to make a decision more or less from the outset on the legal structure you're going to use to trade. Although that's an important decision, luckily, it's not an irrevocable one. You can change structures as your business grows – though not without some cost and paperwork.

The simplest structure is to make all the business decisions yourself and take all the risk personally. You don't have to shoulder all the responsibilities when you start a business, though most people initially do so. It may be great doing everything your way, at last, after the frustrations of working for someone else. But it can be lonely or even scary with no one with whom you can talk over the day-to-day problems and share the responsibility of decision making.

If your business requires substantial investment, or involves other people who'll have a more or less equal hand in the venture alongside you, then your decision about the legal structure of the business is a little more complicated. In this chapter you can find all the important factors to consider when deciding on the legal structure for your business.

Choosing the Right Structure

Different legal frameworks exist for the ownership of a business and not all are equally appropriate for everyone.

Most small businesses in the UK start out as sole proprietorships; however, by the time they register for VAT (value added tax) – in other words, after they're up and running – then owners tend to seek the shelter of limited liability. You can see from the figures in Table 5-1 that as the economic climate turned sour in 2009 more firms chose to incorporate.

Table 5-1 Popular Business Structures (%)

	2008	*2009*
Limited companies	56.6	58.2
Sole proprietorships	25.4	24.4
Partnerships	14.1	13.5

One of the many factors you have to consider when deciding on the legal structure of your business is tax, including VAT and its implications, and I talk about how to manage your tax position in Chapter 14.

But even more compelling reasons than tax to choose one structure over another may exist. Not all sources of finance are open to every type of business. When you know how much money you need either to start up or to grow a business and what you need that money for, you're in a better position to make an informed choice about the best way to structure your business. If you need to raise large sums of money from the outset for research and development, for example, then a limited company may be your only realistic option, with its access to risk capital. And if you're nervous about embroiling your finances with other people's, a partnership isn't an attractive option.

In general, the more money you require and the riskier the venture, the more likely it is that a limited company is the appropriate structure.

The good news is that you can change your legal structure at more or less any time. Even if you go the full distance and form a company and get it listed on the stock exchange, you can delist and go private. Richard Branson (Virgin) and Alan Sugar (Amstrad) have both done this. That's not to say it's easy to dissolve partnerships or shut down companies, but you can do it.

Both your accountant and your lawyer can help you with choosing your legal form. The types of business structures and some of their advantages and disadvantages are shown in Table 5-2.

Table 5-2 Pros and Cons of Various Organisational Structures

Type of Entity	*Main Advantages*	*Main Drawbacks*
Sole proprietorship	Simple and inexpensive to create and operate.	Owner personally liable for business debts.
	Profit or loss reported on owner's personal tax return.	No access to outside capital.
		Life of business restricted to life of owner.
		Limited potential for value creation.
General partnership	Simple and inexpensive to create and operate.	Partners personally liable for business debts.
	Partners' share of profit or loss reported on personal tax returns.	The business is dissolved when a partner dies.
	Potential for some value creation.	Only partners can raise outside capital.
Limited partnership	Non-managing partners have limited personal liability for business debts.	General partners are personally liable for business debts.
	General partners can raise cash without involving outside investors in the management of the business.	More expensive to create than a general partnership.
	Wider access to outside capital than for a sole proprietor.	Life of business restricted to life of first partner to die.
	Potential for some value creation.	

Table 5-2 *(continued)*

Type of Entity	*Main Advantages*	*Main Drawbacks*
Limited company	Owners have limited personal liability for business debts.	More expensive to create and run than partnership or sole proprietorship.
	Some benefits (such as pensions) can be deducted as a business expense.	Owners must meet legal requirements for stock registration, account filing and paperwork.
	Owners can share out the profit and could end up paying less overall.	
	Access to full range of outside capital.	
	Business can live on after founder's death.	
	Potential for value creation.	
	Separate taxable entity.	
Co-operative	Owners have limited personal liability for business debts.	More expensive to create than a sole proprietorship.
	Owners' share of corporate profit or loss reported on personal tax returns.	Owners must meet legal requirements for account filing, registration and paperwork.
	Owners can use corporate loss to offset income from other sources.	Restricted access to outside capital.
		Limited potential for value creation.

Going into Business by Yourself

You may want to develop your own unique ideas for a product or service, and if so, setting up your own business from the drawing board may be your only option. You may want to start a home-based business that you can run in your own time. You may want to start a business because you want to do things the right way, after working for an employer who goes about things in the wrong way.

Doing things your own way is much easier if you're working alone, rather than, say, buying someone else's business that already has its routines and working practices established.

Advantages

Working for and by yourself has several things going for it:

- It may be possible to start the business in your spare time. This allows you to gain more confidence in the future success of your proposed venture before either giving up your job or pumping your life savings into the business.
- If you have limited money to invest in your new venture, you may not need to spend it all at the start of the project. This also means that if things do start to go wrong, it's easier to restrict the losses.
- Starting a business isn't just about money. Setting up and running a successful business has the potential to give you a feeling of personal achievement, which may not exist to quite the same extent if you buy someone else's business, for example.

Disadvantages

Going it alone isn't all fun and games. Some of the disadvantages are:

- Your business will take time to grow. It may not be able to support your current personal financial obligations for many months or years.
- A lot of one-off administration is involved in setting up a new business, such as registering for VAT and PAYE (pay as you earn, or income tax), getting business stationery, setting up phone, fax and Internet connections at your trading premises and registering your business name, in addition to actually trading.

  These tasks can be very time consuming and frustrating in the short term, and very costly in the long run if you get them wrong. Unfortunately, these tasks are often not easily delegated and can be expensive if you get other people to do them. If you buy a business or take up a franchise, these basic administrative tasks should have already been dealt with.
- You have no one to bounce ideas off, or to share responsibility with when things go wrong.
- As a result of the perceived riskiness, generally you may have more difficulty borrowing money to fund a start-up than to invest in an established profitable business.

Settling on sole-trader status

The vast majority of new businesses are essentially one-man (or one-woman) bands. As such, they're free to choose the simplest legal structure, known by terms such as *sole trader* or *sole proprietor*. This structure has the merit of being relatively formality free and having few rules about the records you have to keep. As a sole proprietor you don't have to have your accounts audited or file financial information on your business.

If you're a sole trader, no legal distinction exists between you and your business. Your business is one of your personal assets, just as your house or car is. Following from this, if your business should fail your creditors have a right not only to the assets of the business, but also to your personal assets, subject only to the provisions of local bankruptcy rules (these often allow you to keep only a few absolutely basic essentials for yourself and family). It may be possible to avoid the worst of these consequences by distancing your assets (see Chapter 12 for how to deal with business failure).

The capital to start and run the business must come from you, or from loans. In return for these drawbacks you can have the pleasure of being your own boss immediately, subject only to declaring your profits on your tax return and if necessary applying for a trade licence. (In practice, you'd be wise to take professional advice before starting up.)

Often people who start up on their own don't have enough money to buy into an existing operation, so the do-it-yourself approach is the only alternative.

Building up to Network Marketing

Network marketing, multilevel marketing (MLM) and *referral marketing* are the names used to describe selling methods designed to replace the retail outlet as a route to market for certain products. Although referral marketing has been around since the early part of the last century, for many people it's still unfamiliar territory.

Network marketing is one way of starting a profitable, full-time business with little or no investment. It's also a method of starting a second or part-time business to run alongside your existing business or career. Network marketing is one of the fastest-growing business sectors. Industry turnover has grown from £1 billion ten years ago to £2 billion today.

In most cases network marketing involves selling a product or service that a parent company produces and supplies. You take on the responsibilities of selling the products and introducing other people to the company. You get paid commission on the products/services you sell yourself and a smaller commission on the products/services that the people you've introduced to the company sell. In addition to this, you often get a percentage commission based on the sales of the people that the people you introduced to the company also introduce, and on and on.

Advocates of network marketing maintain that, when given identical products, the one sold face to face (without the cost of maintaining a shop and paying employees and insurance) is less expensive than the same product sold in a store. Additionally, network marketing fans believe that buying a product from someone you know and trust makes more sense than buying from a shop assistant behind a retail counter.

A wide variety of good-quality network marketing companies from all over the world exist for you to choose from. They offer products and services from a wide range of industries – health, telecommunications, household products, technology, e-commerce, adult products and so on. Household names include Amway, Avon, Betterware, Herbalife, Kleeneze and Mary Kay Cosmetics. Choose a product or service that you're interested in because, when it comes to sales, nothing beats enthusiasm and confidence in the product.

Evaluating the pros and cons

Like any other type of business, network marketing has its upside and its downside. Some of the positives are:

- **Little or no start-up costs:** With most companies the investment in a business kit and a range of sample products rarely exceeds £100. The law governing network marketing doesn't allow an investment of more than £200 in the first seven days.
- **The potential to build a substantial business:** By recruiting more and more people to join the company and by those people recruiting more people, your percentages of their sales grow and grow. And, of course, you're still selling at a high rate yourself.
- **A proven business formula:** Network marketing has been around since the early 1900s.
- **Low risk:** Unlike a brand-new business idea that you may have uncovered, network marketing products and services are usually tried-and-tested business concepts. That doesn't mean they can't fail, but if you follow the rules you're less likely to hit the buffers than you would on your own.
- **A great deal of support and advice is often given:** The parent company and the person who brought you into the company have a vested interest in helping you succeed because the more you sell, the more money they make.
- **Flexible hours:** You can sell on a full-time or part-time basis during the hours that suit you and your customers.
- **Highly expandable:** You don't have territory restrictions like conventional salespeople, and with e-commerce

capabilities most parent companies can supply to many countries.

- **Location:** You can run the business from your own home.
- **Personal development:** You build your confidence and increase your communication skills.

Again, as with any business, network marketing isn't all good. The following list shows some of the disadvantages:

- Restrictions on your business practices may exist, for example recruitment, advertising and so on.
- Your business relies heavily on the success of one parent company and its ability to deliver its products/services on time.
- You may not feel comfortable selling to your friends or to strangers.
- Even the best network marketing companies may be thought of as pyramid schemes – see the next section.

One characteristic of network marketing that leads to its all-too-frequent excesses is that everyone can get in for very little money up front; thus, everyone does get in.

Distinguishing pyramids from network marketing

Pyramid selling schemes are sometimes disguised to look like network marketing schemes, but commonly have the following characteristics:

- They encourage participants to make substantial investments in stocks of goods, by offering rewards to participants for getting others to do the same.
- They make little reference to direct selling and the need to achieve consumer sales. Instead, they imply that the main source of rewards comes from getting others to make substantial initial investments.
- They don't offer contracts to participants, nor cancellation rights or the opportunity to buy back unsold goods – all of which are required under UK law.

Quality network marketing companies make sense for people who really believe in a particular product and want to sell it but don't want to, or can't, tie up a lot of money buying a franchise or other business, or don't have a great idea of their own. Just remember to check out the network company using trade associations such as the Direct Selling Association (www.dsa.org.uk). You won't get rich in a hurry, or probably ever, but if you take care you probably won't lose your shirt either.

Working with a Limited Number of Other People

Unless you're the self-contained type who prefers going it alone, you have to work alongside other people to get your business going. Not just suppliers or employees or bankers and the like – everyone in business has to do that to a greater or lesser extent.

The upside of going into business with others is that you have someone on your side to talk to when the going gets tough, and it will do from time to time. Two heads are very often better than one. Also, you have the advantage of extra physical and mental resources when they matter most, from the very outset.

However, it's not a one-sided equation, unfortunately. With other people come other points of view, other agendas and the opportunity to disagree, argue and misunderstand.

Taking on an existing business

If you don't have a solid business idea of your own, with a clear vision and strategy, you can consider using someone else's wholly formed business. You can think of such ventures as virtually a business-in-a-box. Just buy it, take it home, open it up and start trading. Of course it's not always quite that easy, but in broad principle that's what network marketing, franchising and co-operative ventures are all about.

Forming a partnership

A *partnership* is effectively a collection of sole traders or proprietors. Very few restrictions apply to setting up in business with another person (or persons) in partnership, and several definite advantages exist:

- Pooling your resources means you have more capital.
- You bring several sets of skills to the business, hopefully, instead of just one.
- If one of you is ill or disabled, the business can still carry on.

Partnerships are a common structure that people who started out on their own use when they want to expand.

The legal regulations governing partnerships in essence assume that competent businesspeople should know what they're doing. The law merely provides a framework of agreement, which applies 'in the absence of agreement to the contrary'.

In the absence of an agreement to the contrary these rules apply to partnerships:

- All partners contribute capital equally.
- All partners share profits and losses equally.
- No partner shall have interest paid on his capital.
- No partner shall be paid a salary.
- All partners have an equal say in the management of the business.

It's unlikely that all these provisions suit you, so you're well advised to get a partnership agreement drawn up in writing before opening for business.

Partnerships have three serious financial drawbacks that merit particular attention:

- If one partner makes a business mistake, perhaps by signing a disastrous contract without your knowledge or consent, every member of the partnership must shoulder the consequences. Under these circumstances your personal assets can be taken to pay the creditors even though the mistake was no fault of your own.
- If a partner faces personal bankruptcy, for whatever reason, their creditors can seize their share of the partnership. As a private individual you aren't liable for your partner's private debts, but having to buy them out

of the partnership at short notice rather than gaining an unwanted replacement may put you and the business in financial jeopardy.

- If one partner wants to quit the partnership, that partner wants to take the value of their part of the business with them. The remaining partner(s), in effect, has to buy out the partner who's leaving. The agreement you have on setting up the business should specify the procedure and how to value the leaver's share, otherwise resolving the situation is costly. Several options for addressing this issue exist. A few are:

    - The traditional route to value the leaver's share is to ask an independent accountant. This is rarely cost effective. The valuation costs money and worst of all it's not definite and consequently room for argument remains.

    - Another way is to establish a formula; say, eight times the last audited pre-tax profits. This approach is simple but difficult to get right. A fast-growing business is undervalued by a formula using historic data unless the multiple (eight times or whatever) is high; a high multiple may overvalue 'hope' or goodwill, thus unreasonably profiting the leaver.

      You can arrive at the multiplier by looking up the performance of a business similar to the one in question that's listed on a stock market. Such a business has a *P/E (price/earnings) ratio* published in both its accounts and the financial sections of national newspapers. The P/E ratio is calculated by dividing the share price into the amount of profit earned for each share. For example, if a business makes £100,000 profit and has 1,000 shares, the profit per share is £100. If the share price of that company is £10, then its P/E ratio is 10 (100/10). So much for the science, now for the art. Because any business quoted on a stock market is big and its shares are liquid – that is, easy to buy and sell – it's considered more valuable than a small private company. In any event, private firms don't have a published share price. To allow for that you usually discount the P/E ratio by a third to compensate. So, using this example, a private firm in the same line of work as the one listed on a stock market would be given a P/E of approximately 7 (2/3 × 10).

- Under a third option, you can value the assets of the business and use that as a basis for dividing the spoils.

REMEMBER

Even death may not release you from a partnership and in some circumstances your estate can remain liable for the partnership's obligations. Unless you take public leave of your partnership by notifying your business contacts and legally bringing your partnership to an end, you remain liable indefinitely.

Looking at limited partnerships

One option that can reduce the more painful consequences of entering a partnership is to have your involvement registered as a limited partnership. A limited partnership works like this: one or more general partners must be involved with the same basic rights and responsibilities (including unlimited liability) as in any general partnership. In addition there can be one or more limited partners who are usually passive investors. The big difference between a general partner and a limited partner is that the limited partner isn't personally liable for debts of the partnership so long as they play no active part in the business. The most a limited partner can lose is the amount that he:

- Paid or agreed to pay into the partnership as a capital contribution
- Received from the partnership after it became insolvent

The advantage of a limited partnership as a business structure is that it provides a way for business owners to raise money (from the limited partners) without having either to take in new partners who are active in the business, or to form a limited company. Often, a general partnership that's been operating for years creates a limited partnership to finance expansion.

Checking out co-operatives

If making money is much lower on your list of priorities for starting up in business than being involved in the decisions of an ethical enterprise, then joining a co-operative or starting your own is an idea worth exploring.

JARGON ALERT

A *co-operative* is an autonomous association of people united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.

You must have at least seven members at the outset, though they don't all have to be full-time workers at first.

Like a limited company, a registered co-operative has limited liability for its members and must file annual accounts.

Although the most visible co-operatives are the high-street shops and supermarkets, pretty well any type of business can operate as a co-operative.

If you choose to form a co-operative, you can pay from £90 to register with the Chief Registrar of Friendly Societies. Not all co-operatives bother to register because doing so isn't mandatory, but if you don't register, the law regards your co-operative as a partnership with unlimited liability.

You can find out everything you need to know about the size, structure and prospects of co-operatives in the UK in a free 36-page report that you can download from www.uk.coop/resources/documents/uk-co-operative-economy-2010.

Finding Your Way to Franchising

Franchising can be a good first step into self-employment for those with business experience but no actual experience of running a business – often the case with those who are looking for something to do following a corporate career.

Franchising is a marketing technique used to improve and expand the distribution of a product or service. The franchiser supplies the product or teaches the service to you, the franchisee, who in turn sells it to the public. In return for this, you pay a fee and a continuing royalty, based usually on turnover. The franchiser may also require you to buy materials or ingredients from it, which gives it an additional income stream. The advantage to you is a relatively safe and quick way of getting into business for yourself, but with the support and advice of an experienced organisation close at hand.

The franchising company can expand its distribution with minimum strain on its own capital and have the services of a highly motivated team of owner-managers. Franchising isn't a path to great riches, nor is it for the truly independent spirit, because policy and profits still come from on high.

According to the latest annual franchise survey produced by the National Westminster Bank and the British Franchise Association (www.british-franchise.org), in 2010 some 34,800 franchised units operated through 842 franchise chains (McDonald's, Domino's Pizzas, Kall Kwik and the like). The turnover of the industry grew to £11.8 billion, up by 42 per cent over the past decade and twice as fast as the economy as a whole. The number of people employed in franchising, directly and indirectly, is estimated to be 465,000. London and the South East, the South West, North West, West and East Midlands are the main regions for franchising activity. London and the Southeast alone account for 30 per cent of all franchise units. For more details on franchising, check out the nearby sidebar 'Facts about franchising in the UK in 2010'.

Although franchising eliminates some of the more costly and at times disastrous bumps in the learning curve of working for yourself, it's not an easy way to riches. Although 90 per cent of franchisees report they're trading profitably, the number of those claiming high levels of profitability remains low, at around 10 per cent. Still, this performance compares well with the depth of the 1990 recession when just 70 per cent of franchises traded profitably.

Some people make wild claims about how much safer a franchise is when compared to a conventional start-up. The long-established big franchise chains are relatively safe, though a few big names have got into trouble, but the smaller and newer ones are as vulnerable as any other venture in the early formative years.

Facts about franchising in the UK in 2010

The following list shows some of the findings of the annual NatWest/British Franchise Association franchise survey that for 26 years has been monitoring the performance, attitudes and opinions of the UK franchise sector.

- The average annual turnover for a franchised business is £353,000.
- The average start-up cost of a franchise is £46,700.
- Property services is the largest sector, followed by personal services, Internet services, retailing, and food and catering.
- Over three quarters of franchise systems in the UK are operated by a UK-based franchisor.
- Twenty per cent of franchisees operate more than one franchise unit.
- Eighty-four per cent of franchisees are satisfied in their relationship with their franchisor.
- On average, franchisors interview 7.2 people for each franchise opened.
- Seventy-nine per cent of all franchisees are married.
- The average age of new franchisees is 42; 6 per cent are 30 or younger and 9 per cent are over 60.

- Over a third of new franchisees are women.
- A third of new franchisees are graduates.
- Thirteen per cent of new entrants are of Asian background.

Looking at franchise types

Franchises can be clustered under these three main headings:

- **Business franchises:** These businesses typically have premises and employees. They require a higher level of investment, typically in the range of £20,000–£120,000, in stock, equipment and premises. Large numbers of business franchises are available in such areas as retailing, food services and business services such as high-street printing shops.
- **Investment franchises:** Here, you're talking about initial investments of over £120,000. Hotels and some of the larger and more established fast-food outlets come into the top range of this category at around £750,000.The essence of this type of franchise is that the franchisee is unlikely to work in the business day to day. People operating investment franchises typically operate several similar franchises in nearby areas.
- **Job franchises:** This is where you're buying the rights to operate what's essentially a one-person business, such as plumbing, building services or a recruitment business. These require a financial investment in the £7,000–£20,000 range and can be described as 'buying a job'. However, with back-up in the way of training, customer leads, advertising and so on from the franchiser, these are suitable for someone with little

capital but who has a specific area of expertise or is willing to be trained in it, such as cleaning or vehicle repair and maintenance services.

Defining a franchise

A franchise agreement is just like any business contract, in that it sets out what each party is expected to do and what can happen if they don't.

The main ingredients of the franchise agreement are:

- Permission to use a business name and so be associated with that bigger enterprise
- The right for the franchiser to set and enforce business and product standards, such as the use of ingredients, cooking processes, opening times, staff uniforms and so forth
- An obligation for the franchiser to provide help, training and guidance in all aspects of operating the business
- A definition of the way in which the rights to operate the franchise are to be paid for, for example royalties on sales, initial purchase fee, marketing levy, mark-up on goods and services provided, and so forth

The British Franchise Association expects its members to follow its code of practice, and you can find out more on its website: www.thebfa.org.

Although membership of the BFA and adhering to a code of practice are helpful, they're not a guarantee of success for your franchise. You should be looking for a shortlist of as many as six opportunities, acquiring as much advice as you can get from franchisers, from franchisees, from your bank and from other professional advisers.

Before deciding on a particular franchise you must consult your legal and financial advisers, as well as ask the franchiser some very searching questions:

- Has the franchiser operated at least one unit for a year or so as a pilot unit in the UK? This is an essential first step before selling franchises to third parties. Otherwise, how can the franchiser really know all the problems, and so put you on the right track?
- What training and support is included in the *franchise package*, the name given to the start-up kit provided by the franchiser? This package should extend to support staff over the launch period and give you access to back-up advice.
- How substantial is the franchise company? Ask to see the balance sheet (take it to your accountant if you can't understand it). Inquire into the track record of the directors (including their other directorships).

Sometimes a major clearing bank offers financial support to buy a particular franchise, which is an encouraging sign that the company is in good financial health. At least you know that the concept is tried and tested and to some extent the business is reputable. However, as with everything to do with starting up a business, the buck stops with you.

You can meet franchisers and hear their pitch at one of the dozen or so franchise exhibitions held around the country each year. The BFA Diary page (www.thebfa.org/diary.asp) gives details of dates and venues.

Founding a Larger Company

If your business looks like it will need a substantial amount of money from the outset and will be taking on the risk of customers owing money, as with any manufacturing venture, then the legal structures looked at so far may not be right for you.

In this section you can find out about the advantages and disadvantages of going for a limited company, or buying out a company already in business.

Opting for a limited company

As the name suggests, in this form of business your liability is limited to the amount you contribute by way of share capital.

Two shareholders, one of whom must be a director, can form a limited company. You must also appoint a company secretary, who can be a shareholder, director or an outside person such as an accountant or lawyer.

You can buy a company ‘off the shelf’ from a registration agent, and then adapt it to suit your own purposes. This involves changing the name, shareholders and articles of association and takes a couple of weeks to arrange. Alternatively, you can form your own company.

A limited company has a legal identity of its own, separate from the people who own or run it. This means that, in the event of failure, creditors’ claims are restricted to the assets of the company. The shareholders of the business aren’t liable as individuals for the business debts beyond the paid-up value of their shares. This applies even if the shareholders are working directors, unless of course the company has been trading fraudulently. In practice, the ability to limit liability is restricted these days as most lenders, including the banks, often insist on personal guarantees from the directors. Other advantages include the freedom to raise capital by selling shares.

Disadvantages include the legal requirement for the company's accounts to be audited and filed for public inspection.

When a company is first registered it must send to Companies House (www.companieshouse.org.uk), the place where all business details and accounts are kept, a copy of its memorandum and articles of association and Form 10, which contains the address of the company's registered office and details of its directors and company secretary. The directors' details are current names, any former names, date of birth, usual residential address, occupation, nationality and other directorships. For the secretary only the names and address are required. Companies House organises or attends a variety of seminars and exhibitions to support and advise businesses and to support new directors and secretaries. You can find details of these on the events section of the Companies House website (www.companieshouse.org.uk/about/chEvents.shtml).

Buying out a business

Buying out an existing business is particularly well suited to people who have extensive experience of general business management but lack detailed technical or product knowledge.

When you buy an established business, you not only pay for the basic assets of the business, but also the accumulated time and effort that the previous owner spent growing the business to its present state. You can think of this extra asset as *goodwill.* The better the business, the more the 'goodwill' costs you.

Advantages of buying a business include:

- You acquire some of the experience and expertise you don't have. It's much easier, and almost invariably less costly, to learn from the mistakes other people have made in the past, rather than making all these mistakes yourself.
- You gain both access to your potential customers and the credibility of a trading history from the outset, which can save months if not years of hard work in building relationships.
- If the business you buy is already profitable, you can pay yourself a living wage from the outset.
- Bank financing may be easier to acquire for an established business than for a riskier start-up business.

Disadvantages of buying a business include:

- You run the risk of acquiring the existing unsolved problems and mistakes of the person who's selling it.
- Identifying the right potential acquisition and negotiating a purchase can take a very long time, and there's no guarantee that you'll succeed at your first attempt.
- The professional fees associated with buying a business can be a significant, though necessary, cost. If you buy a very small business, the total professional fees associated with the transaction are a major percentage of the total cost of your investment, perhaps as much as 15 or 20 per cent. Experienced solicitors and accountants are vital to this process. They're your

safeguards to ensure that you know exactly what you're buying.

Contact these organisations to find out more about buying a business and to see listings of businesses for sale:

- Businesses For Sale (www.businessesforsale.com) has over 55,000 businesses for sale in the UK, as well as listings of firms in Spain, the USA, Australia, Canada, India, Ireland, New Zealand and France.
- Christie & Co (www.christie.com, tel. 0207 227 0700) claims to have the largest database of businesses for sale in Europe. It's the recognised market leader in the hotel, catering, leisure and retail markets and is also expanding into healthcare.
- Daltons (www.daltonsbusiness.com) has an online database of over 30,000 businesses for sale around the United Kingdom and some overseas countries.

Looking at Legal Issues in Marketing

Nothing in business escapes the legal eye of the law and marketing is no exception. If anything, marketing is likely to produce more grey areas from a legal point of view than most other aspects. You have patent and copyright issues to consider, for example.

A number of vital aspects of your business distinguish it from other similar firms operating in or near to your area of operations. Having invested time, energy and money in acquiring these distinguishing factors, you need to take steps to preserve any benefits they provide you with. Intellectual property, often known as IP, is the generic title covering the area of law that allows people to own their creativity and innovation in the same way that they can own physical property. The owner of IP can control and be rewarded for its use, and this encourages further innovation and creativity.

The following four organisations can help direct you to most sources of help and advice across the entire intellectual property field. They also have helpful literature and explanatory leaflets and guidance notes on applying for intellectual property protection:

- The Intellectual Property Office (www.ipo.gov.uk)
- European Patent Office (http://www.epo.org)
- US Patent and Trade Mark Office (www.uspto.gov)
- World Intellectual Property Association (www.wipo.int)

I cover the most common types of intellectual property in the following sections.

Naming your business

The main consideration in choosing a business name is its commercial usefulness. You want one that lets people know as much as possible about what your company does. So choose a name that conveys the right image and message.

Whichever business name you choose, it has to be legally acceptable and abide by the rules of the Business Names Act 1985. Detailed information on this subject is available from the Business Names section at the Companies House website. Go to www.companieshouse.gov.uk and click on Guidance Booklets and then Incorporation and Names.

Looking at logos

You don't have to have a logo for your business, but it can build greater customer awareness. A logo may be a word, typeface, colour or shape. The McDonald's name is a logo because of its distinct and stylistic writing. Choose your logo carefully. It should be one that's easily recognisable, fairly simple in design and able to be reproduced on everything associated with your business. As far as the law is concerned a logo is a form of trademark (see 'Registering a trademark', later in this chapter).

Protecting patents

Patents can be regarded as contracts between inventors and the state. The state agrees with the inventor that if he is prepared to publish details of his invention in a set form and if it appears that he has made a real advance, the state will then grant him a monopoly on his invention for 20 years. The inventor can use the monopoly period to manufacture and sell the innovation; competitors can read the published specifications and glean ideas for their research, or they can approach the inventor and offer to help to develop the idea under licence.

If you want to apply for a patent it's essential not to disclose your idea in non-confidential circumstances. If you do, your invention is already 'published' in the eyes of the law, and this could invalidate your application. Ideally, the confidentiality of the disclosure you make should be written down in a confidentiality agreement and signed by the person to whom you're making the disclosure. The other way is to get your patent application on file before you start talking to anyone about your idea. You can talk to a Chartered Patent Agent in complete confidence because they work under strict rules of confidentiality.

The process of filing an application, and publishing and granting the patent takes some two and a half years. The associated costs can be high: subject matter searches cost upwards of £500, validity searches from £1,000 and infringement searches from £1,500. The relevant forms and details of how to patent are available from the Patent Office at www.patent.gov.uk, and you can find more information in Trevor Baylis Brands' and Henri Charmasson's *Patents, Copyrights & Trademarks For Dummies* (Wiley).

Registering a trademark

A *trademark* is the symbol by which the goods of a particular manufacturer or trader can be identified. It can be a word, a signature, a monogram, a picture, a logo or a combination of these.

To qualify for registration the trademark must be distinctive, must not be deceptive and must not be capable of confusion with marks already registered. Excluded are national flags, royal crests and insignia of the armed forces. A trademark can only apply to tangible goods, not services (although pressure is mounting for this to be changed).To register a trademark you or your agent should first conduct preliminary searches at the Trade Marks Branch of the Patent Office to check that no conflicting marks are already in existence. You then apply for registration on the official trademark form and pay a fee (currently £200). Registration is initially for ten years. After this, it can be renewed for further periods of ten years at a time, with no upper time limit.

If you've been using an unregistered trademark for some time and it can be construed that customers closely associate it with your product, the trademark will have acquired a 'reputation' that gives it some protection legally, but registration makes it much simpler for the owner to have recourse against anyone who infringes the trademark.

Detailing your design

You can register the shape, design or decorative features of a commercial product if it's new, original, never published before or – if already known – never before applied to the product you have in mind. Protection is intended to apply to industrial articles to be produced in quantities of more than 50.

Design registration only applies to features that appeal to the eye – not to the way the article functions.

To register a design in the UK, you should apply to the Design Registry at https://www.ipo.gov.uk/types/design.htm and send a specimen or photograph of the design plus a registration fee (currently £60 plus £40 for each additional design). If you want protection of your design outside the UK, you generally have to make separate applications for registration in each country in which you want protection.

Controlling a copyright

Copyright gives protection against the unlicensed copying of original artistic and creative works – articles, books, paintings, films, plays, songs, music and even engineering drawings. To claim copyright the item in question should carry the symbol © with the author's name and date.

No other action is required to take out copyright, if it's relevant to your business. For further information you can access the Copyright Service through the Patent Office website (www.ipo.gov.uk/types/copy.htm).

Copyright doesn't last forever. Its duration depends on the type of copyright involved and can be anything from 25 to 70 years after the creator's death.

Abiding by fair business rules

The whole way in which businesses and markets operate is the subject of keen government interest. It's not a good idea, for example, to gang up with others in your market to create a *cartel*, in which you all agree not to lower your prices or to compete with each other too vigorously.

Any such action may be brought to the attention of the Office of Fair Trading (OFT; www.oft.gov.uk). The OFT's job is to make markets work well for consumers. Markets work well when businesses are in open, fair and vigorous competition with each other for the consumer's custom.

The OFT:

- Ensures that consumer legislation and regulations are properly enforced
- Takes action against unfair traders
- Encourages codes of practice and standards
- Offers a range of information to help consumers understand their rights and make good choices
- Liaises closely with other regulatory bodies that also have enforcement powers

Setting terms of trade

All business is governed by terms of trade, which are in turn affected by *contractual* relationships. Almost everything done in business, whether it's the supply of raw materials, the sale of goods and services or the hire of machinery, is executed under contract law. This is true whether the contract is in writing or verbal – or even merely implied.

Only contracts for the sale of land, hire purchase and some insurance contracts have to be in writing to be enforceable.

To make life even more complicated, a contract can be part written and part oral. So statements made at the time of signing a written contract can legally form part of that contract. For a contract to exist three events must take place:

- An offer
- An acceptance
- A consideration – some form of payment

When selling via the Internet or mail order the contract starts when the supplier 'posts' an acceptance letter, a confirmation or the goods themselves – whichever comes first.

Goods purchased via the Internet or mail order are also covered by the Distance Selling Regulations, under which customers have seven working days after they've received the goods to change their minds and return them. They don't need a reason and can get a full refund.

You must also give customers:

- Information about the company they're dealing with, such as the business name, registered and trading addresses and directors
- Written confirmation of the order – by fax, letter or email
- A full refund if their goods don't arrive by the date agreed in the original order; if no date was agreed they must be delivered within 30 days
- Information about cancellation rights
- Protection against credit card fraud

You have to meet certain standards by law for the supply of goods and services. Over and above these you need your own terms and conditions to avoid entering into 'contracts' you didn't intend. You'll need help to devise these terms. The following four basic propositions govern your conditions:

- The conditions must be brought to the other party's attention before he makes the contract.
- The last terms and conditions specified before acceptance of an offer apply.
- If any ambiguity or uncertainty exists in the contract terms they'll be interpreted against the person who inserted them.
- The terms may be interpreted as unreasonably unenforceable being in breach of various Acts of Parliament.

The Office of Fair Trading (www.oft.gov.uk) and the Trading Standards Institute (www.tradingstandards.gov.uk), can provide useful information on most aspects of trading relationships.

Describing your goods

You can't make whatever claim you like for the performance of your goods or services. If you state or imply a certain standard of performance for what you're selling, your customers have a legally enforceable right to expect that to happen. So if you state your new slimming method not only makes people lose weight but also makes them happier, richer and more successful, then you'd better deliver on all those promises.

The Trades Descriptions Acts and related legislation make it an offence for a trader to describe goods falsely. The Acts cover everything from the declared mileage of second-hand cars to the country of manufacture of a pair of jeans.

The Trading Standards Service operates at county level throughout the UK to ensure that trading laws are met. You can contact your branch by phone or via the website (www.tradingstandards.gov.uk).

Dealing with payment problems

Unless you're able to insist on payment before you send out your product or supply your service, getting paid isn't always as simple as sending out a bill and waiting for the cheque. Customers may dispute the bill, fairly or unfairly.

The Small Claims Court offers you an opportunity to collect money when you find a regular court too expensive. True, for very small cases the process isn't always cost-effective, and occasionally you have problems collecting on your judgment. But the Small Claims Court should still be part of your business's collection strategy. Check out information on the Small Claims Court at www.hmcourts-service.gov.uk.

One other route to less painful debt recovery (or problem resolution) is to go to arbitration. That is where an independent person listens to both sides of the case and makes a decision based more on common sense, fairness and practicalities than merely on the law. This is a cheaper, quicker and less intimidating process. You can find out all about the process and locate an arbitrator from the Chartered Institute of Arbitrators (http://www.ciarb.org) or its European branch (www.european-arbitrators.org).

Chapter 6

Preparing the Business Plan

In This Chapter

- Turning your ideas into plans
- Satisfying financiers' concerns
- Making your plan stand out
- Using software
- Preparing for an elevator pitch

Perhaps the most important step in launching any new venture or expanding an existing one is the construction of a *business plan.* Such a plan must include your goals for the enterprise, both short and long term; a description of the products or services you offer and the market opportunities you anticipate; and finally, an explanation of the resources and means you need to achieve your goals in the face of likely competition.

Preparing a comprehensive business plan along these lines takes time and effort – the Cranfield School of Management estimates anywhere between 200 and 400 hours, depending on the nature of your business and how much data you've already gathered. Nevertheless, such an effort is essential if you're both to crystallise and focus your ideas, and test your resolve about starting or expanding your business.

The core thinking behind business plans and their eventual implementation is strategic analysis. The strategic analysis refines or confirms your view of what's really unique about your proposition. Or to put it another way, ‘Why on earth would anyone want to pay enough for this to make me rich?’

After completion, your business plan serves as a blueprint to follow that, like any map, improves users’ chances of reaching their destination.

Finding a Reason to Write a Business Plan

A number of important benefits arise from preparing a business plan. All these benefits add up to one compelling reason: businesses that plan make more money than those that don’t and they survive for longer too.

> The research on planning generally shows a positive relationship between planning and business performance. Businesses that follow a well-thought-out plan generally out-perform businesses with no plans or informal plans in every relevant category. Businesses that continue to update their plans throughout their life enjoy significantly more success than businesses that don’t.

I cover key reasons for writing up your business plan in the following sections.

Building confidence

Completing a business plan makes you feel confident in your ability to set up and operate the venture because you’ve put together a plan to make it happen. It may even compensate for lack of capital and experience, provided of course you have other factors in your favour, such as a sound idea and a sizeable market opportunity for your product or service.

Testing your ideas

A systematic approach to planning enables you to make your mistakes on paper, rather than in the marketplace. One potential entrepreneur made the discovery while gathering data for his business plan that the local competitor he thought was a one-man band was in fact the pilot operation for a proposed national chain of franchised outlets. This had a profound effect on his market entry strategy!

Another entrepreneur found out that, at the price he proposed charging, he would never recover his overheads or break even. Indeed, *overheads* and *break even* were themselves alien terms before he embarked on preparing a business plan. This naive perspective on costs is by no means unusual. (I cover this whole area in Chapter 13.)

Showing how much money you need

Your business plan details how much money you need, what you need it for and when and for how long you need it.

Because under-capitalisation and early cash-flow problems are two important reasons for new business activities failing, if you have a soundly prepared business plan you can reduce these risks of failure. You can also experiment with a range of alternative viable strategies and so concentrate on options that make the most economic use of scarce financial resources.

To say that your business plan is the passport to sources of finance is an exaggeration. It does, however, help you to display your entrepreneurial flair and managerial talent to the full and to communicate your ideas to others in a way that is easier for them to understand so that they appreciate the reasoning behind your ideas. These outside parties could be bankers, potential investors, partners or advisory agencies. As soon as they know what you're trying to do they're better able to help you.

Providing planning experience

Preparing a business plan gives you an insight into the planning process. This process – not simply the plan that comes out of it – is itself important to the long-term health of a business. Businesses are dynamic, as are the commercial and competitive environments in which they operate. No one expects every event recorded on a business plan to occur as predicted, but the understanding and knowledge created by the process of business planning help prepare the business for any changes it may face, and so enable it to adjust quickly.

Satisfying financiers' concerns

If you need finance, examining what financiers expect from you is important if you're to succeed in raising those funds.

The media often claim that no shortage of money exists for new and growing businesses, and that the only scarce commodities are good ideas and people with the ability to exploit them. A potential entrepreneur may find this hard to believe. One major venture capital firm alone receives several thousand business plans a year – venture capitalists put up risk capital to invest in other businesses on behalf of institutions such as pension funds. It examines only 500 or so in any detail, pursues fewer than 25 to the negotiating stage and only invests in 6 of those.

To a great extent the decision of whether to proceed beyond an initial reading of the plan depends on the quality of the business plan used in supporting the investment proposal. The business plan is your ticket of admission, giving you your first and often only chance to impress prospective sources of finance with the quality of your proposal.

To have any chance at all of getting financial support, your business plan must be the best that you can write and it must be professionally packaged. The plans that succeed meet all the following requirements.

Presenting evidence of market orientation and focus

You need to demonstrate that you recognise the needs of potential customers, rather than simply being infatuated with an innovative idea. Financiers usually cold-shoulder business plans that occupy more space with product descriptions and technical explanations than with explaining how products are going to be sold and to whom. They rightly suspect that these companies are more of an ego trip than an enterprise.

But market orientation isn't enough in itself. Financiers want to sense that entrepreneurs know the one or two things their business can do best and that they're prepared to concentrate on exploiting these opportunities.

Demonstrating customer acceptance

Financiers like to know that your new product or service is going to sell and is being used, even if only on a trial or demonstration basis.

The founder of Solicitec, a company selling software to solicitors to enable them to process relatively standard documents such as wills, had little trouble getting support for his house-conveyancing package after a leading building society had tried and approved his product for its panel of solicitors.

If you're only at the prototype stage, financiers have no immediate indication that, when made, your product is going to appeal to the market. They have to assess your chances of succeeding without any concrete evidence. Under these circumstances you have to show that the problem your innovation seeks to solve is a substantial one that a large number of people are prepared to pay for.

As well as evidence of customer acceptance, you need to demonstrate that you know how and to whom your new product or service may be sold, and that you have a financially viable means of doing so.

Owning a proprietary position

Exclusive rights to a product through patents, copyright, trade mark protection or a licence helps to reduce the apparent riskiness of a venture in financiers' eyes, because these can limit competition, for a while at least.

One participant on a Cranfield enterprise programme held patents on a revolutionary folding bicycle that he'd designed at college. No financial institution was prepared to back him in manufacturing the bicycle, but funds were readily available to enable him to make production prototypes and then license the design to established bicycle makers throughout the world.

However well protected legally a product is, marketability and marketing know-how generally outweigh ‘patentability’ in the success equation. A salutary observation made by an American professor of entrepreneurship revealed that less than 0.5 per cent of the best ideas contained in the *US Patent Gazette* in the last five years have returned a dime to the inventors.

Making believable forecasts

Entrepreneurs are naturally ebullient when explaining the future prospects for their businesses. They frequently believe that the sky’s the limit when it comes to growth, and that money (or rather the lack of it) is the only thing standing between them and their success.

When you’re looking for venture capital, the providers of that capital are looking for rapid growth in your business. However, remember that financiers deal with thousands of investment proposals each year, and already have money tied up in hundreds of business sectors. Therefore they already have a perception of what the accepted financial results and marketing approaches currently are for any sector. Any new company’s business plan showing projections that are outside the ranges perceived as acceptable within an industry raises questions in the investor’s mind.

Make your growth forecasts believable – support them with hard facts where possible. If they’re on the low side, then approach the more cautious lending banker, rather than a venture capitalist. The former often sees a modest forecast as a virtue, lending credibility to the business proposal as a whole.

Writing Up Your Business Plan

In these sections, I give you some guidelines to make sure that your plan attracts attention and succeeds in the face of some fierce competition. More than 1,000 businesses start up in the United Kingdom each day, and many of those are looking for money or other resources that they're hoping their business plan can secure for them. Making your business plan the best it can be gives it a chance to stand out.

Defining your readership

Clearly, a business plan is more effective if you write it with your readers in mind. This involves some research into the particular interests, foibles and idiosyncrasies of those readers. Bankers are more interested in hearing about certainties and steady growth, and venture capitalists are also interested in dreams of great things to come. *Business angels*, who put their own money at risk, like to know how their particular skills and talents can be deployed in the business.

You can benefit from carrying out your reader research before the final editing of your business plan, because you should incorporate something of this knowledge into the way you present it. You may find that you have to create slightly different versions of the business plan for different audiences. This makes readers feel that you're addressing the proposal to them rather than them just being the recipient of a 'Dear Sir or Madam' type of missive. However, the fundamentals of the plan remain constant.

Choosing the right packaging

Appropriate packaging enhances every product and a business plan is no exception. Most experts prefer a simple spiral binding with a clear plastic cover front and back. This makes it easy for the reader to move from section to section, and it ensures that the document survives the frequent handling that every successful business plan is likely to get.

A letter-quality printer, using size 12 typeface, double spacing and wide margins, gives you a pleasing and easy-to-read plan.

Deciding on layout and content

No universal business plan format exists. That being said, experience has taught me that certain styles are more successful than others. Following these guidelines results in an effective business plan that covers most requirements. Not every sub-heading may be relevant to you, but the general format is robust.

The following list contains the elements of an effective business plan, one that covers most requirements. You may not need all these sections, and you may need others to cover special requirements.

- The **cover** should show the name of your business, its website, Facebook/Twitter pages, physical address, phone number(s) including a mobile, fax number(s), e-mail address, contact name and the date on which this version of the plan was prepared. It should confirm that this is the current view on the business's position and financing needs.
- The **title page**, immediately behind the front cover, should repeat the cover information and also give the founder's name, address and phone number. A home phone number can be helpful, particularly for investors, who often work irregular hours too.

- The **executive summary** is ideally one page, but certainly no longer than two, and contains the highlights of your plan. Writing this summary is a difficult task, but it's the single most important part of your business plan. Done well, it can favourably dispose the reader from the outset. If you do the executive summary badly, or not at all, then the plan may not get beyond the investor's mail room. This one page (or two pages) must explain:

  - The current position of the company, including a summary of past trading results
  - A description of the products or services, together with details of any rights or patents and of your competitive advantage
  - The reasons customers need this product or service, together with some indication of market size and growth
  - A summary of forecasts of sales and profits, together with short- and long-term aims and the strategies you'll employ
  - How much money you need to fund the growth and how and when the provider of that finance can benefit

  Write the executive summary only after you complete the business plan itself.

- The **table of contents**, with page numbers, is the map that guides readers through the business plan. If that map is obscure, muddled or even missing, then you're likely to end up with lost or irritated readers who are in no mind to back your proposal. You should list and number each main section and give it a page number.

Elements within each section should also be numbered: 1, 1.1, 1.2 and so on.

- Details of the **business and its management** should include a brief history of the business and its performance to date, if any, and details on key staff and their work experience, current mission, legal entity, capital structure and professional advisers.
- A description of **products and services**, their applications, competitive advantage and proprietary position. Include details on state of readiness of new products and services and development cost estimates.
- The **marketing** section should provide a brief overview of the market by major segment showing size and growth. Explain the current and proposed marketing strategy for each major segment, covering price, promotion, distribution channels, selling methods, location requirements and the need for acquisitions, mergers or joint ventures, if any.
- Information on **management and staffing** should give details on current key staff and on any recruitment needs. Include information on staff retention strategies, reward systems and training plans.
- The **operations** section describes how you make your products and services and fulfil orders, how you assure quality standards and how you can meet output.
- The summary of the key **financial data** includes ratios together with a description of the key controls used to monitor and review performance.
- Include **financing requirements** needed to achieve the planned goals, together with how long you need the money for. Also demonstrate how the business would proceed using only internal funding. The difference

between these two positions is what the extra money helps to deliver.

- **E-commerce** isn't just about selling goods and services online, though that's important. It covers a range of activities that you can carry out online to make your business more efficient. These solutions extend across the supply chain, from ordering your raw materials right through to after-sales service. It can incorporate market intelligence gathering, customer relationship management and a whole range of back-office procedures. Your business plan should show how you plan to tackle this area.
- Include **major milestones** with dates. For example: get prototype for testing by 20 December, file patents by 10 January or locate suitable premises by such and such a date.
- **Risk assessment** features high on your reader's list of concerns, so you should anticipate as many as you can, together with your solution. For example: 'Our strategy is highly dependent on finding a warehouse with a cold store for stock. But if we can't find one by start date we will use space in the public cold store 10 miles away. This is not as convenient but it will do.'
- Detail an **exit route** for venture capitalists and business angels. Typically, they're looking to liquidate their investments within three to seven years, so your business plan should show them how much money they can make and how quickly.

  If you think you need long-term investment (see Chapter 8 for more about equity financing), then you need to say something about who may buy the business and when you may be able to launch it on a stock market.

- **Appendixes** include CVs of the key team members, technical data, patents, copyrights and designs, details of professional advisers, audited accounts, consultants' reports, abstracts of market surveys, details of orders on hand and so on.

Writing and editing

The first draft of the business plan may have several authors and it can be written ignoring the niceties of grammar and style. The first draft is a good one to talk over with your legal adviser to keep you on the straight and narrow, and with a friendly banker or venture capitalist. This can give you an insider's view of the strengths and weaknesses of your proposal.

When you've revised the first draft, then comes the task of editing. Here grammar, spelling and a consistent style do matter. The end result must be a crisp, correct, clear, complete plan no more than 20 pages long. If you're not an expert writer you may need help with editing. Your local librarian or college may be able to help here.

Maintaining confidentiality

Finding an investor or a bank to lend to your business may take weeks or months. During that time, potential investors diligently gather information about the business so that they don't have surprises later about income, expenses or undisclosed liabilities. The business plan is only the starting point for their investigations.

If you and the prospective financiers are strangers to one another, you may be reluctant to turn over sensitive business information until you're confident that they're serious. (This isn't as sensitive an issue with banks as it is with business angels and venture capital providers.) To allay these fears, consider asking for a confidentiality letter or agreement.

A confidentiality letter suffices in most circumstances. But if substantial amounts of intellectual property are involved you may prefer to have a lawyer draft a longer, more formal confidentiality agreement, also known as a non-disclosure agreement (NDA). That's okay, but you (and perhaps your lawyer as well) should make sure that the proposed document contains no binding commitment on you. The confidentiality letter should be limited to their agreement to treat the information as strictly confidential and to use the information only to investigate lending or investing in the business, and to the other terms set out in the letter.

You can find more information on NDAs as well as links to organisations that can help you put together an NDA at this Business Link website: (www.businesslink.gov.uk > Exploit your ideas > Protecting your intellectual property > Non-disclosure agreements)

Doing due diligence

Don't be surprised if the investor wants to learn about your personal financial status, job or business history. Investors are interested in your financial stability, your reputation for integrity and your general business savvy because they will, in effect, extend credit to you until you deliver them the interest or return they're expecting on their money. That's what the *due diligence* process is all about.

Usually, the due diligence process, which involves a thorough examination of both the business and its owners, takes several weeks, if not longer. But that depends on how much money your plan calls for and from whom you're trying to raise it. (I cover raising finance in Chapter 8.)

Accountants and lawyers usually subject your track record and the business plan to detailed scrutiny. You're then required to warrant that you've provided *all* relevant information, under pain of financial penalties. The cost of this due diligence process, rarely less than a big five-figure sum and often running into six, is borne by the firm raising the money, but is paid out of the money raised, if that's any consolation.

Using Business Planning Software

You may consider taking some of the sweat out of writing your business plan by using one of the myriad software programmes on the market. You need to take some care in using such systems, because the result can be a bland plan that pleases no one and achieves nothing worthwhile.

Don't buy a package with several hundred business plans covering every type of business imaginable. The chances are that the person who wrote the plans knows far less than you do about your business sector and can add little or no value to your proposition. Worse still, at least an even chance exists that the reader of your plan has seen the fruits of these packaged plans before and may be less than enthusiastic to see yet another one.

You may well find it beneficial to use the test shown in Figure 6-1 as an uncomplicated form of self-assessment, before becoming bogged down in number-crunching software.

Figure 6-1: Assessing the content of your business plan.

By answering the questions below you will get some idea of how well your business plan is progressing. Score 1, 2, or 3 following the key below for each of the questions. Mark the options closest to your instincts, and be honest. Then add up your scores and refer to the results at the end of the questionnaire to see how you scored and to check the potential of your plan.
Whatever your score, remember that this type of self-assessment test is broad brush. It is designed only to give an indication of whether you have the basic attitude, instincts, and capabilities to make a success of launching a home-based business.
If your score is low, the chances are that you do not. If it is high, the opposite is true.

1 = Made a start 2 = Some data only 3 = Comprehensive

Title page ☐1 ☐2 ☐3

Name of business contact details, date of business plan, contents

Executive summary ☐1 ☐2 ☐3

Your details; summary of key strategies; why you are better or different; summary of profit projections; summary of financial needs

The business and its management ☐1 ☐2 ☐3

You and your team's relevant experience; business goals and objectives; legal structure of the business

The marketing strategy ☐1 ☐2 ☐3

Market segment analysis; pricing strategy; promotion plans; product mix and range; e-commerce strategy; location; selling strategy

Management and staffing ☐1 ☐2 ☐3

Staff numbers; roles and responsibilities; recruitment needs

Operations ☐1 ☐2 ☐3

What facilities and equipment are needed; what services will be brought in?

Legal issues ☐1 ☐2 ☐3

What intellectual protection do you have as a barrier to entry; what other legal issues affect your business?

Financial forecasts ☐1 ☐2 ☐3

Summary of financial projections; monthly cash flows; profit and loss accounts; balance sheets; break-even analysis

Financing requirements ☐1 ☐2 ☐3

How much money do you need; what is it needed for; how much money can you provide; how much do you need to raise from outside; what security is available?

Results:

9 points or less:
You still have a lot more information to gather or decisions to make. No serious plan can be drawn up at this stage.
Between 10 and 20 points:
You have made progress, but still have a few gaps to fill. Concentrate your efforts on completing your plan.
More than 20 points:
Your plan is now complete and ready for final editing.

Recognising the limits of software

Good business planning software provides a useful structure to drop your plan into and may provide a few helpful spreadsheets and templates for financial projections and market analysis. It also provides a valuable repository for your work in progress as you assemble the evidence to convince yourself and others that your business can succeed.

What software doesn't do is write a convincing business proposition by itself. The maxim 'garbage in, garbage out' applies to business planning software just as it does to everything to do with computers.

The other danger is that you end up with spreadsheet solutions – numbers just pumped into the financials – without any evidence of the underlying logic to support them.

Use business planning software as an aid and not a crutch. Go beyond that and you may end up worse off than if you'd started with a blank sheet of paper.

Reviewing systems

This section provides reviews of some business planning software packages and related websites that have been used to good effect:

- **BizPlanit.Com** (www.bizplanit.com; email biz@bizplanit.com): BizPlanIt.Com's website has free resources offering information, advice, articled links to other useful sites and a free monthly newsletter, the Virtual Business Plan, to pinpoint information. It also has an email service, providing answers to business plan questions within 24 hours.
- **NatWest** (www.natwest.com/business/business-school/business-guides/planning-and-management/business-plan/default.ashx): They claim to offer a business plan in 60 seconds. They also offer some

tips on writing plans and at the bottom of the page is a link to download NatWest's free business planning software.

- **Royal Bank of Canada** (www.rbcroyalbank.com/business): This site has a wide range of useful help for entrepreneurs. Click on Resource Center, then Starting a Business and then Create the Plan to access its business plan writer package and sample business plans.
- **The Royal Bank of Scotland:** The bank offers a free business plan writer to download at www.rbs.co.uk/business/banking/g2/planning.ashx#tabs=section1.

Presenting Your Plan

Anyone backing a business does so primarily because she believes in the management of the business. She knows from experience that things rarely go according to plan, so she must be confident that the team involved can respond effectively to changing conditions. You can be sure that any financier you're presenting to has read dozens of similar plans, and is well rehearsed. She may even have taken the trouble to find out something about your business and financial history.

Starring in showtime

When you present your business plan to financial backers, your goal is to create empathy between yourself and your listeners. You may not be able to change your personality, but you can take a few tips on presentation skills. Eye contact, tone of speech, enthusiasm and body language all have a part to play in making a presentation go well.

Wearing a suit is never likely to upset anyone. Shorts and sandals just set the wrong tone. Serious money calls for serious people and even the Internet world is growing up.

Rehearse your presentation beforehand, having found out how much time you have. Explain your strategy in a business-like manner, demonstrating your grasp of the competitive market forces at work. Listen to comments and criticisms carefully, avoiding a defensive attitude when you respond.

Use visual aids and if possible bring and demonstrate your product or service. A video or computer-generated model is better than nothing.

Allow at least as much time for questions as you take in your talk. Make your replies to questions brief and to the point. If your potential investors want more information, they can ask. This approach allows time for the many different questions that must be asked either now or later, before an investment can proceed.

Making an elevator pitch

You never know when the chance to present your business plan may occur – maybe even in a lift between floors (hence the term *elevator pitch*). You need to have every aspect of your business plan in your head and know your way around the plan backwards, forwards and sideways. It’s as well to have a 5-, 10- and 20-minute presentation ready to run at a moment’s notice.

One entrepreneur was given a chance to make a presentation of her business plan to the most powerful and influential person in her industry. This person could make or break new businesses and frequently did. The opportunity was a ten-minute ride in a chauffeur-driven car between the Dorchester hotel and Harrods. She had no room to demonstrate the product, set up flip charts or PowerPoint presentations or to involve the team. She had just enough space and time to convey a handful of powerful facts with passion, conviction and authority. Fortunately, the entrepreneur concerned had rehearsed her impromptu presentation and was completely prepared to seize the opportunity presented. She built up £20 million business barely a decade after taking that fateful car ride.

Chapter 7

Getting Help

In This Chapter

- Locating help and advisory agencies
- Looking at Business Link
- Checking out Local Enterprise Agencies
- Exploring incubators
- Inspiring inventors
- Getting help for younger entrepreneurs

The fact that you've decided to start up your own business doesn't mean you have to do everything yourself. Even if you've rejected the idea of taking on a partner or going into a franchise chain, you can still get expert help and advice with nearly every aspect of your business, before you start up, while you're starting up and even long after you've established your enterprise.

In taking outside help and advice you're in good company. Each working day over 10,000 people use the services of a small business advisory organisation. Most are simple telephone enquiries, but others involve face-to-face counselling sessions. Several hundred organisations are specifically concerned with providing help, advice and resources (including finance) for small businesses and those starting them. For the most part, these services are provided free or at a very low cost, at least at the outset.

Many of these organisations have been set up, or at least been encouraged to set up, by both national and local governments, who have come to realise how valuable small businesses are to communities and economies. (Chapter 2 addresses these issues in more depth.)

Although lots of people and organisations can help you get started in business, in the end you have to make the decisions. That's not to knock the great advice and wisdom that many in help agencies such as Business Link or Enterprise Agencies and the like have to offer. However, no one can step into your shoes and see the world through your eyes. But by the same token, the final responsibility for choice of action rests with you. Listen to advice and take your own decisions.

In this chapter I introduce some of the organisations you'd be mad not to talk to if you want to get an expert outsider's view on the problems you're tussling with to get off to the best possible start.

Connecting with Government services

That the UK Government is keen to help small business should come as no big surprise. New small businesses are a key source of new jobs and eventually of tax payments. But just because the government's aims are selfish doesn't mean you shouldn't tap into any help you can get. Exactly what that help will be varies from time to time, both in terms of the type of help and its amount and form.

You can expect government help, advice and support in some or all of these areas:

- Sources of finance, both debt and equity (See chapter 8 for more on these types of funds)
- Advice on training schemes
- Grants and incentives
- Online information on all aspects of business
- Assessing yourself against the attributes and skills needed to launch and run a business
- Deciding what type of business is most appropriate
- Discovering the range of issues that you need to consider in developing your business proposition
- Deciding on the right sort of finance to start and grow your business
- Becoming aware of the regulations that apply when starting a business
- Understanding the steps required for informing public authorities that you're launching your business

The contact point for access to all government help is the Department for Business Innovation and Skills website (www.bis.gov.uk). Also at the time of writing the Business Link website (www.businesslink.gov.uk) can be used to find information on the full range of advice and support for small businesses from both government and non-government agencies.

Linking to Local Enterprise Agencies (LEAs)

Some 110 Local Enterprise Agencies (LEAs) in the UK deliver business support services under contract to Business Link – sometimes they're located in the same premises. The key purpose of LEAs is to promote economic regeneration by helping small firms to set up. Local Enterprise Agencies are companies limited by guarantee, typically set up as partnerships between big companies and organisations in the private sector and local authorities, with support from central government depending on their individual circumstances. LEAs support over 100,000 pre-starts, nearly 25,000 start-ups and 130,000 established businesses – totalling over 250,000 clients – across the country every year.

LEAs are independent and no single group of sponsors controls them. Big businesses, the major banks and accountancy bodies created them in response to government pressure. The thinking is that big business has much to gain from a successful small business sector and has a responsibility to pass the knowledge and experience it has gained on to the next generation of entrepreneurs. The private sector generally retains the largest sponsorship stake in LEAs, and almost invariably a local businessperson chairs an LEA. LEAs have great, in-depth experience of the local small and medium enterprise (SME) economy, with the ability to draw on a local network of specialist skills, such as accountants, lawyers and banks.

Typically, LEAs directly or indirectly provide advice, information, counselling and training on a comprehensive range of business issues, as well as very often providing shared workspace with access to some business services. They're involved with all types of SMEs, including pre-starts, start-ups, sole traders, partnerships, co-operatives and limited companies.

LEAs provide business services including business counselling, training, consultancy and in some cases managed workspace.

You can find your nearest Local Enterprise Agency in the phone book, at the National Federation of Enterprise Agencies (NFEA) website, www.nfea.com, or by phoning the NFEA on 01234 831621. The NFEA maintains a current directory of all its members on its website.

You can find out where your nearest LEA is at this website address: www.nfea.com/find-local-business-support.html.

Choosing Small Business Associations

The services of government-supported help agencies are often free, but a growing army of commercial or semi-commercial self-help organisations is present in the field. Their basic premise is that if small firms can band together to buy goods, services or advice, or to influence government policy, they're more likely to be effective than on their own. I cover the more established of these organisations in the following sections.

The Federation of Small Businesses

The Federation of Small Businesses (FSB; website: www.fsb.org.uk; tel: 01253 336000) is a national organisation with 213,000 members that protects small firms' interests and fights for their rights. The Federation has the resources to take major test cases of importance to small business through the expensive legal process leading to the House of Lords and the European Courts if necessary. It's been particularly effective when dealing with taxation and employment matters.

The Federation maintains press and parliamentary offices at Westminster, and in Glasgow, Cardiff and Belfast; an administration office in Blackpool; and regional offices elsewhere in the UK. Thirty-three regional committees and over 194 branch committees, run by people who themselves operate small businesses and who donate their time to the Federation, complement the professional staffs.

For people thinking of starting their own business the FSB offers legal, environmental, fire and premises tips, as well as advice on many other issues that small business owners may have to address as the business grows. The FSB also provides information on other agencies that may be of use or assistance when starting up.

Membership costs range from £150 per annum, including a one-off registration fee of £30 for someone working on his own, up to £900 for a firm employing more than 151 people. (Prices exclude VAT.)

Amongst the valuable services on offer from the FSB is a legal benefits package, providing access to legal advice from qualified lawyers 24 hours a day, 365 days a year; tax advice from Revenue-trained specialists; information and documentation on employment, tax and commercial law; and insurance cover for legal and tax professional fees and statutory awards in the event of an employment dispute or full tax enquiry.

Forum of Private Business

The mission of the Forum of Private Business (FPB; website: www.fpb.co.uk; tel 0845 612 6226) is to influence laws and policies that affect private businesses and support members to grow profitably. Through its 25,000 members the Forum researches and distributes a referendum a number of times each year and keeps both members and government aware of how small firms feel about key topical issues. Membership fees are based on a sliding scale depending on the size of your business, starting at £175 per annum. Membership of the Forum brings the following benefits:

- A direct influence on laws and policies affecting your business, for example employment law, uniform business rates, taxation, red tape, bank services, late payment and so on
- Information on tap when you need it with unlimited free access to the Member Information Service, on any issue affecting your business
- User-friendly management tools to help your business stay within the law – for example, the FPB Employment Guide (produced with the TUC), the FPB Health & Safety Guide (produced with the TUC) and the FPB Bank Finance Review, which looks at areas such as bank performance, bank switching, tracking transactions and transmission charges

The FPB also runs a late payment Hall of Shame where you can provide information on seriously late payers and get pre-warning on which firms may not be worth doing business with.

The British Chambers of Commerce

Though not aimed exclusively at small businesses, the British Chambers of Commerce (www.britishchambers.org.uk) offer an extensive range of services for business starters. Their national network of accredited chambers is managed and developed by their business membership and monitored at the national level to ensure that they deliver appropriate products and services to prescribed standards. They're funded by membership subscriptions.

Currently, over 135,000 businesses belong to a chamber in the accredited network, from growth-oriented start-ups to local and regional subsidiaries of multinational companies, in all commercial and industrial sectors, and from all over the UK.

British Chambers of Commerce have access to a range of benefits geared to help businesses big or small succeed and grow. With over 2,500 staff covering more than 100 locations, their network provides a ready-made management support team for any business anywhere in Britain.

Business training, information resources, networking and savings on essential overheads, all of which are tailored to individual business needs, are on offer from local chambers. Increasingly, many of their services are also available online.

The British Chambers of Commerce are also part of the global network of chambers of commerce, and for existing or potential exporters simply no better route exists to the global marketplace.

Their regular surveys, consultations and reports provide grass-roots business opinion and have strong influence on government ministers and officials, members of Parliament, and other decision makers and opinion formers.

Chambers of commerce have a long history of providing relevant business training, coaching and support for their members and the wider business community. They're one of the largest training providers in the country, offering a huge range of development opportunities all designed to help improve your business performance. To find a course go to Find a Course on www.britishchambers.org.uk and choose a topic from the drop-down menu.

A few more strings to your bow

Literally hundreds of organisations and associations exist thatare in the business of helping you and your businesses. Here are a few more that you should consider taking a look at to see whether their services could match your needs:

- **Association of Chartered Certified Accountants** (www.accaglobal.com) is a major accounting body. It offers 34 free fact sheets on every aspect of starting a business, including recruiting, advertising, grants, setting up an office, researching your market and effective selling (go to General Public, Technical Activities, Subject Areas, Small Business and finally Start-ups).
- **Asian Business Association** (website: www.abauk.org; tel: 0161 615 5034) is a membership association costing £100 a year to join. Its 700 members sponsor training, lobby government and act as a networking resource for their communities.
- **Black Business Association** (website: www.bbassoc.org.uk; tel: 0121 260 0515) focuses on the

issues of business and entrepreneurship in the African Caribbean community. Annual fees are £150.

- **British Association of Women Entrepreneurs** (website: www.bawe-uk.org; tel: 01786 446044.
- **The British Franchise Association** (www.thebfa.org) has a directory of country franchise associations from which you can find information about franchising in each country (go to International and then Franchise Associations).
- **eBusiness Clubs** (www.ebusinessclubs.co.uk) is a free service delivered through British chambers of commerce aimed at small businesses, offering access to a range of activities including events, ICT support and information from business experts. The strapline 'How technology can improve business performance' explains the central purpose of the clubs.
- **EverywWoman** (website: www.everywoman.co.uk; tel: 0870 746 1800) is a free service (registration required) giving access to over 30,000 like-minded women who are serious about business. The site has plenty of advice, tips, fact sheets and online tools to help business starters.
- **Homeworking.com** (www.homeworking.com), started in 1999, is a resource rather than a job directory and is full of useful tips and helpful warnings about the thousands of scam businesses on offer to would-be homeworkers.
- **Institute of Directors** (IoD; website: www.iod.com; tel: 020 7766 8888) is the club for directors, membership of which costs £312 a year. For that you get access to a prestigious central London office and other offices around the UK and in their branches inBelgium, Bermuda, Cyprus, France, Germany, Malta, Monaco and

the Netherlands. Business information and research is provided for you by the IoD's expert researchers and bespoke business advisers on tax and law. The IoD is also considered one of the best networking associations for entrepreneurs.

- **PRIME Business Club** (website: www.primebusinessclub.com; tel: 0208 765 7833) claims to be the only national organisation dedicated to helping people aged over 50 set up in business. It has all the usual material on starting a business on its site, but has an emphasis on the issues older people face, such as dealing with tax credits and pensions.
- **Telework Association** (website: www.tca.org.uk; tel: 0800 616008) costs from £34.50 a year to join. It has 7,000 members who either work or are running a business from home. You get a bi-monthly magazine, a teleworking handbook with ideas for tele-businesses and access to their help line covering all aspects of working from home.

Universities and Colleges

Universities and colleges around the country offer training programmes , support and other initiatives to help small business founders both before and after start-up. Some such initiatives include:

- City University (www.city.ac.uk/cae/cfa/business/small_business/starting_up_business.html) offer a business start up course. It highlights the key issues to be considered, from marketing and sales to financial and legal requirements. Topics include the psychology behind starting up your own business, processes involved, business formats, market research and the importance of cash flow. The course focuses on the key issues to be considered and is delivered by experienced business owners, managers and entrepreneurs. This part time course costs £300.

- London Jewellery School (www.londonjewelleryschool.co.uk/5-day-jewellery-business-intensive-/bookings/72/) run a five day "Set Up Your Own Jewellery Business Intensive Certificate". This covers business set up skills including marketing yourself, legal requirements, pricing and selling your jewellery, getting into galleries and shops and photographing your jewellery. This course costs £650.

- London College Of Fashion, University Of The Arts London (www.fashion.arts.ac.uk/shortcourses/60037.htm) offer a number of business start-up courses. In their Starting Fashion Retail Business course, costing £290, participants will discover the advantages and disadvantages of running their own retail outlet. It covers market research types and methods, identifying location and suitable premises, targeting consumer behaviour, how to beat the competition, store environment, promotional activities and loyalty initiatives.

- Cranfield School of Management: (www.som.cranfield.ac.uk/som >Open programmes>Growing businesses) The Business Growth and Development Programme is the UK's most successful and longest-running programme for ambitious owner managers and MDs. This programme provides a unique opportunity for you to step back from the day-to-day demands of running your business. By the end of the programme you will have developed a comprehensive and robust strategy and plan for the future. Expect to pay around £8,000 for the privilege, but in return you can expect a substantial payback on your investment. Lord Bilimoria (Cobra Beer) and Angus Thirwell (Hotel Chocolate) are among the alumni of this programme.

Hotcourses (www.hotcourses.com) provide information on some 3,000 business courses run in UK colleges and universities. The company aims to be the best in the world at helping people find the course that is right for them, whatever stage they are in life. With offices in Chennai, India and London they are the largest publisher of guides to courses, colleges and universities.

Entering an Incubator

Incubators – also known as accelerators, science parks, innovation centres, technology parks and a whole variety of other names coined over the years – are places where new businesses can set up in a benign environment, with support services and advice close at hand. The many names try to describe the tasks that incubators perform.

Finding the right type of incubator

Varieties of incubators now co-exist in the market, with radically different aims and objectives. Some, such as those founded by entrepreneurs and venture capital firms – the ‘for profit’ variety – only want to get rich by helping entrepreneurs to get rich. That goal at least has the merit of transparency. Some incubators have revenue models that can make the incubator rich without necessarily benefiting anyone else that much.

Governments and local governments are more concerned with job creation than wealth, and universities, another major player, want jobs for the students and funding for faculty research rather than riches themselves. Big corporate firms run private incubators to encourage firms that may buy their products or services, or create career opportunities for their more entrepreneurial and potentially less fickle employees.

These incubators are havens for entrepreneurs with innovative or technology-based business ideas that need more help than most to bring to fruition. Such ventures usually have more potential than other business start-ups, but they're also more risky. No one knows how many entrepreneurs graduate from these incubators each year, but a reasonable supposition is that each of the estimated 4,000 incubators has two or three graduates each year. So 10,000 or so 'eggs' are hatched in a safe environment each year – not a big number in terms of business start-ups. Across Europe and the US somewhere between 3 and 4 million new businesses get going in most years. But for at least some of the entrepreneurs who get into an incubator, their chances of success are better than if they go it alone.

Getting into an incubator

You almost invariably face an application process to get into any business incubator. All that does vary is the process itself. Some incubators positively invite and encourage the informal approach, some are highly structured, some have their own models and techniques that they believe can sort the wheat from the chaff. All the application processes take time and if they didn't you'd have cause for concern. After all, if an incubator takes in anyone without any serious consideration of what the person can do to help their businesses, that particular incubation process is unlikely to be of much value. Most application processes require some sort of business plan. This may be little more than an executive summary created online with your application. Or it may be a more comprehensive written document setting out your latest thinking on what's so special about you and your big idea. Then comes the interview and after that the decision.

Most incubators have details of their application process on their websites, as well as case examples of successful clients. Some have business plan application templates to help in the process. You can expect to take anything from a couple of weeks to a couple of months to get through the process.

How much does incubation cost? If you're just paying rent and for services as you use them then the cost of being in an incubator is transparent. Such not-for-profit incubators are usually aimed at non-business-educated people who have good ideas to create traditional small businesses, usually with little technology involved. These incubators are frequently government funded, often in underdeveloped cities, and provide mentoring, business development and office space. The typical equity stake required ranges from none to nominal (some require CEOs to give back to the community).

But if providing an incubator with an equity stake in your business is involved, as it surely is in any for-profit incubator, then the cost can run the scale from a few per cent of the business to an outrageously expensive 30 to 50 per cent. The amount you pay doesn't always relate to the value you receive. It depends on your business needs and the scale of the opportunity you want to exploit.

Contact either UK Business Incubation (www.ukbi.co.uk) or United Kingdom Science Park Association (UKSPA; www.ukspa.org.uk) to find out all you need to know about incubators or innovation centres that may help you achieve your ambitious goals.

Assisting Inventors

Each year over 7,000 hopeful inventors in the UK file patents to protect their intellectual property from poachers. With a success rate of getting patented ideas to market of lower than 2 per cent, inventors need all the help they can get. Check out these organisations that can smooth out the path:

- **The Institute of Patentees and Inventors** (website: www.invent.org.uk; tel: 0871 226 2091) has among its 1,000 members not only inventors but also patent agents, marketers and others who can provide expert advice to its membership on the complex issues relating to invention and innovation. These issues cover intellectual property rights and topics as diverse as originality searching, manufacturing practices, pricing practices, presentation techniques, funding and other subjects relating to the exploitation of an invention. The Institute also produces a journal titled *Future and the Inventor* at least once per annum and issues it to members. The journal contains information pertinent to inventors and details the forthcoming activities of the Institute. Annual membership is £70 with a joining fee of £15.
- **International Federation of Inventors' Societies** (IFIA; website: www.invention-ifia.ch) is a not-for-profit, non-governmental organisation created by seven European inventor associations in 1968. Its current membership comes from more than 88 countries. The Federation has web links to its 100 member organisations and to 345 other organisations of probable use to inventors, as well as details of reference books, guides, surveys, studies, conferences, seminars, workshops, expert group

meetings, lectures, competitions and awards for inventions.

- **NESTA** (website: www.nesta.org.uk; tel: 020 7438 2500) is the National Endowment for Science, Technology and the Arts – an independent body with a mission to make the UK more innovative. They help and invest in early-stage companies, inform policy and deliver practical programmes that inspire others to solve the big challenges of the future. They aim to bring the best ideas, new flows of capital and talented people together, and encourage them to develop them further.
- **Trevor Baylis Brands** (website: www.trevorbaylisbrands.com; tel: 05601 290240) founded by Trevor Baylis, famous for inventing the clockwork radio. Trevor Baylis Brands provides help with ideas and inventions to other inventors. They hope that they can help anyone with a good idea or invention to protect and sell it.

If protecting your invention is appropriate for your business, check out Chapter 5, 'Protecting patents'.

Helping Young Entrepreneurs

Under-25s are a fast-growing segment of the business start-up market. Even if you aren't in that age group, the organisations in this section can help get your son or daughter off to a flying start.

Attracting Livewire

Livewire (www.shell-livewire.org) is a national programme supported by Shell, an oil multinational, to help young entrepreneurs start their own businesses.

Part of the Shell UK community investment programme, Shell Livewire helps young people (aged 16–30) set up in business with information, advice and support, including how to write a business plan and how to carry out market research. Livewire has helped 600,000 young people to explore starting their own businesses as well as awarding over £3 million in cash prizes since 1982.

Livewire's website contains free downloadable booklets on how to carry out market research and how to write a business plan, as well as a Start a Business Toolkit CD-Rom that's sent to you in the post after your initial free registration.

Livewire also runs annual Young Business Start-Up Awards, where the winner of the UK final wins £10,000.

On the Livewire website you can create your free online business profile and connect with other young entrepreneurs from around the world, find new business contacts and suppliers, blog about your latest products or services, share photos and ideas, post classified ads, event listings and videos, or chat with other members online.

Trusting the Prince's Trust

The Prince's Trust (www.princes-trust.org.uk) helps 14- to 30-year-olds develop confidence, learn new skills and get into work. It offers opportunities when no one else will. So if you've got an idea for a business but no one will give you the money to get it off the ground, the Prince's Trust may be able to provide you with finance and advice. The Prince's Trust can offer:

- Advice on employment options
- Business skills training
- Business planning support
- Start-up funding
- Ongoing support from a mentor
- Access to a wide range of free and discounted products and services. This includes their free legal helpline, sponsored by Barclays

Gaming his way to fame

David Darling, a schoolboy entrepreneur, created a multi-million-pound company from modest beginnings – his first venture operated from his grandparents' garden shed. As a teenager growing up in the early 1980s, he developed his first digital game and placed an advert in a specialist magazine. The exercise was a success. Darling, founder of Codemasters, owns a substantial slice of a business that has grown to span the globe. With its central campus and studios in the heart of the UK, the company operates through its network of European offices, its art and animation studio in Kuala Lumpur, Malaysia and its new US office in Los Angeles, the capital of America's entertainment industry. The company has significantly strengthened its international distribution reach, including a new partnership with Warner Bros. Home Video in North America.

Darling and his brother Richard were fascinated by the new technology of computer games. They were avid readers of *Popular Computing Weekly*, a specialist magazine for Atari, Commodore and Sinclair users. One section of the publication was devoted to programming, featuring the computer codes for popular games as well as tuition and advice. The technology was primitive and with the help of the magazine the two brothers were able to copy simple codes for games such as Space Invaders. Next they started to develop games, initially for themselves.

They decided to test the market and saved up the money for a half-page advertisement in *Popular Computing Weekly*. The price was £70, which they raised by missing school dinners for weeks.

They created their own advert and logo – a Superman-type character – with the help of a friend whose father ran an advertising design company. Under the name Galactic Software, they offered '14 great games from America' for £10. Although they had merely hoped to make enough money to cover the cost of the advert, in the event 40 readers replied, generating £400 of sales. Encouraged by their success the brothers ran a second and third advert in consecutive issues. After the third some 500 orders came in, which was more work than two people could manage, especially with exams approaching. In response Darling employed the services of a music-duplication business in Bridgwater, Somerset. It made copies of tapes for local bands and he struck a deal, paying the company to copy the 14 games at the rate of 50p per tape.

The first company vehicle was a very second-hand Honda moped bought for £60 to collect the tapes, and Darling used his grandparents' garden shed as a warehouse.

After the Darling brothers sat their exams, they went into business full time.

Not all participants in the Trusts programmes get funding. Individual cases are assessed on the basis of their own merits and the riskiness of the venture.

Each year the Prince's Trust helps about 13,000 young people to set up in business. Over 71 per cent of all start-up applications to the Trust have been converted into new ventures – creating almost 18,000 businesses in just five years. One in ten of those businesses has a turnover in excess of £1 million.

Learning by doing – the Young Enterprise motto

Young Enterprise (www.young-enterprise.org.uk), founded in 1962, is based on the Junior Achievement model that's been running in America since 1919. Its aim is to enable young people aged between 4 and 25 to develop skills and knowledge for business and enterprise through setting up and running their own company with the support of representatives from the business community. Young Enterprise programmes also focus on individual development of attitudes and qualities for enterprise, such as problem solving, decision making and management skills.

Your youngsters may not rush home to tell you about this opportunity, but you can tell them. For would-be entrepreneurs this may be a much better way to spend a few summer weeks than just loafing around!

Their Start-up Programme is, in their own words, 'an inspirational year long journey as a real start-up business – Young Enterprise business consultants inspire and guide students through the planning, creation and management of their own company.'

They must be doing something right because each year their business volunteers inspire over 300,000 young people.

Chapter 8

Finding the Money

In This Chapter

- Working out how much outside money you need
- Looking at the different types of money available to you
- Choosing the best source of money for you
- Finding money to work with

Businesses need a continuous flow of customers, products or services to sell, and space to work from or store unsold goods. But they need money to make all these things happen. The more the business actually does, the more money it needs.

Even during the recent world Credit Crunch small businesses needed and, despite some anecdotal evidence to the contrary, accessed money. The latest British Banking Association (BBA; www.bba.org.uk) statistics published on 30 July 2010 showed that on a daily average basis banks were making available around £27 million of new term lending to small businesses each working day. Over the preceding 12 months, banks – the major but by no means the only source of money for new and small businesses – had lent out £54.5 billion in long and short-term loans, just a squeak ahead of the £51.8 billion they'd put up three years ago when I wrote the second edition of this book.

Starting a business on the road to success involves ensuring that you have sufficient money to survive until the point where income continually exceeds expenditure. You need a steady flow of money from many different sources along the way. Data from a recent survey by Warwick Business School of small and medium enterprises (SMEs; businesses with up to 250 employees) shows that over a three- year period about 55 per cent make use of a personal or business credit card; 53 per cent use an overdraft; 24 per cent use a term loan; 6 per cent have access to a grant; 3 per cent use invoice discounting; and 3 per cent use equity finance. Karan Bilimoria, founder of Cobra Beer and one of my former students, raised money from almost every source imaginable in the decade or so it took to get his business from start-up to £100 million annual turnover. (Check out the Entrepreneurs section of www.startups.co.uk for his story.)

This chapter helps you to find the right type of money for your business and avoid common pitfalls.

Assessing How Much Money You Need

You should work out from the outset how much money you need to get your business off the ground. If your proposed venture needs more cash than you feel comfortable either putting up yourself or raising from others, then the sooner you know the better. Then you can start to revise your plans. The steps that lead to an accurate estimate of your financial requirements start with the sales forecast, which you prepare as part of the feasibility testing that I cover in Chapter 4, along with advice on estimating costs for initial expenditure such as retail or production space, equipment, staff and so on.

Forecasting cash flow is the most reliable way to estimate the amount of money a business needs on a day-to-day basis.

Do’s and don’ts for creating a cash-flow forecast:

- Do ensure that your projections are believable. This means you need to show how you're going to achieve your sales.
- Do base projections on facts not conjecture.
- Do describe the main assumptions that underpin your projections.
- Do explain what the effect of these assumptions not happening to plan could be. For example, if your projections are based on recruiting three salespeople by month three, what would happen if you could only find two suitable people by that date?
- Do for all forecasting come up with best and worst outcomes as well as the most likely outcomes.
- Do make sure that you include things like job losses and losses of confidence in the markets that you serve. After all, even if your products and services are excellent, if people have lost confidence because of the bad actions of one of your competitors, you may suffer also.
- Don't use data to support projections without saying where it came from.
- Don't forget to allow for seasonal factors. At certain times of the year most businesses are influenced by regular events. Sales of ice cream are lower in winter than in summer, sales of toys peak in the lead-up to Christmas and business-to-business sales dip in the summer and Christmas holiday periods. So rather than taking your projected annual sales figure and dividing by 12 to get a monthly figure, you need to consider what effect seasonal factors may have.
- Don't ignore economic factors such as an expanding (or shrinking) economy, rising (or falling) interest rates and

an unemployment rate that is so low that it may influence your ability to recruit at the wage rate you want to pay.

- Don't make projections without showing the specific actions that can get those results.
- Don't forget to get someone else to check your figures out – you may be blind to your own mistakes, but someone else is more likely to spot the flaws in your projections.

Projecting receipts

Receipts from sales come in different ways, depending on the range of products and services on offer. And aside from money coming in from paying customers, business owners may, and in many cases almost certainly will, put in cash of their own. However, not all the money necessarily goes in at the outset. For example, you can budget so that £10,000 goes in at the start, followed by sums of £5,000 in months four, seven and ten respectively.

You may be drawing on other sources of outside finance, say from a bank or investor, but these are best left out at this stage. In fact, the point of the cash-flow projection, as well as showing how much money the business needs, is to reveal the likely shortfall after you, the owner, have put what you can into the business and the customers have paid up.

Be sure to have contingency approaches in place, in case people are late in paying you.

You should total up the projected receipts for each month and for the year as a whole. You're well advised to carry out this process using a spreadsheet program, which saves you from any problems caused by faulty maths.

A sale made in one month may not result in any cash coming into the business bank account until the following month, if you're reasonably lucky, or much later if you're not. Make sure you know the ways in which people pay their bills in the sectors of which you're working.

Estimating expenses

Some expenses, such as rent, rates and equipment leases, you pay monthly. Other bills, such as telephone, utilities and bank charges, come in quarterly.

If you haven't yet had to pay utilities, for example, put into your forecast your best guesstimate of how much you're going to spend and when. Marketing, promotion, travel, subsistence and stationery are good examples of expenses you may have to estimate. You know you face costs in these areas, but they may not be all that accurate as projections.

After you've been trading for a while, you can get a much better handle on the true costs you're likely to incur.

Total up the payments for each month and for the year as a whole.

The accounting convention is to show payments out and negative sums in brackets, rather than with minus signs in front.

Working out the closing cash balances

This is crunch time, when the real sums reveal the amount of money your great new business needs to get it off the ground. Working through the cash-flow projections allows you to see exactly how much cash you have in hand, or in the bank, at the end of each month, or how much you need to raise. This is the closing cash balance for the month. It's also the opening cash balance for the following month, because that's the position you're carrying forward.

Testing your assumptions

Little disturbs a financier more than a firm that has to go back cap in hand for more finance too soon after raising money, especially if you should've seen and allowed for the additional requirement at the outset.

So in making projections you have to be ready for likely pitfalls and the unexpected events that knock your cash flow off target. Forecasts and projections rarely go to plan, but you can anticipate the most common pitfalls and to some extent allow for them.

You can't really protect yourself against freak disasters or unforeseen delays, which can hit large and small businesses alike. But some events are more likely than others to affect your cash flow.

In particular watch out for sales taking longer to come in than you thought. Customers take time to make decisions, particularly if they already have a satisfactory alternative supplier. Also make sure they will pay on time. Costs are also a difficult area to predict as not all are easy to anticipate. Finding out, for example, that your motor insurance will be much higher as a consequence of using a car for your business is one cost missed from projections.

Even if you haven't anticipated events you can allow for them when estimating financing needs. Analysis using a cash-flow spreadsheet enables you to identify worst-case scenarios that can knock you off-course. After this you end up with a realistic estimate of the financing requirements of the business or project.

You can check out potential customers by using a credit reference agency such as Snoop4 Companies (www.snoop4companies.co.uk) for businesses or Experian (www.experian.co.uk) for private individuals. Basic credit reports cost between around £3 and £35 and may save you time and money if you have any reservations about a potential customer's ability to pay.

During periods of economic downturn, recessions to you and me, unsurprisingly customers take longer to settle their bills. Big firms, though perhaps a safer bet and more likely to survive, are rarely sympathetic to a small firm's plight. Expect them to go to the wire when it comes to settling up.

Research by Bacs Payment Schemes Limited (www.bacs.co.uk), the organisation behind Direct Debit and Bacs Direct Credit, published in March 2010 shows that since the Credit Crunch struck British small and medium enterprises (SMEs) are having to wait an average of 41 days longer than their original agreed payment terms before invoices are paid.That's an increase of 9.5 days compared to before the Crunch.

Reviewing Your Financing Options

Knowing how much money you need to get your business successfully started is an important first step, but it's only that – a first step. Many sources of funds are available to small firms. However, not all are equally appropriate to all firms at all times. These different sources of finance carry very different obligations, responsibilities and opportunities. You have to understand the differences to allow an informed choice.

Most small firms confine their financial strategy to long-term or short-term bank loans, viewing other financing methods as either too complex or too risky. In many respects the reverse is true. Almost every finance source other than banks shares some of the risks of doing business with you to a greater or lesser extent.

Deciding between debt capital and equity capital

At one end of the financing spectrum lie shareholders – either individual *business angels* who put their own money into a business, or corporate organisations such as *venture capital providers* (also known as venture capitalists or VCs), who provide equity capital that buys a stake in a business. These investors share all the risks and vagaries of the business alongside you and expect a proportionate share in the rewards if things go well. They're less concerned with a stream of dividends – which is just as well because few small companies ever pay them – and instead hope for a radical increase in the value of their investment. They expect to realise this value from other investors who want to take their place for the next stage in the firm's growth, rather than from any repayment by the founder. Investors in new or small businesses don’t look for the security of buildings or other assets to underpin their investment. Rather, they look to the founder’s vision and the core management team’s ability to deliver results.

At the other end of the financing spectrum are debt financiers – banks that try hard to take no risk and expect some return on their money irrespective of your business’s performance. They want interest payments on money lent, usually from day one. They too hope that the management is competent, but they’re more interested in making sure that either you or the business has some type of asset such as a house that they can grab if things go wrong. At the end of the day, and that day can be sooner than the borrower expects, a bank wants all its money back, with interest. Think of bankers as people who help you turn part of an illiquid asset such as property into a more liquid asset such as cash – for a price.

Understanding the differences between lenders, who provide debt capital, and investors, who provide equity or share capital, is central to a sound grasp of financial management.

In between the extremes of shareholders and the banks lie a myriad of other financing vehicles, which have a mixture of lending or investing criteria. You need to keep your business finances under constant review, choosing the most appropriate mix of funds for the risks you plan to take and the economic climate ahead. The more risky and volatile the road ahead, the more likely taking a higher proportion of equity capital is to be appropriate. In times of stability and low interest, higher borrowings may be more acceptable.

As a rule of thumb, you should use debt and equity in equal amounts to finance a business. If the road ahead looks more risky than usual, go for £2 of equity to every £1 of debt.

Table 8-1 illustrates some of the differences between risk-averse lenders and risk-taking investors.

Table 8-1 Comparing Benefits of Lenders and Investors

Category	*Lenders*	*Investors*
Interest	Paid on outstanding loan	None, though dividends sometimes paid if profits warrant it
Capital	Repaid at end of term or sooner if lender has concerns	Returned with substantial growth through new shareholders
Security	Either from assets or personal guarantees	From belief in founders and their business vision

If your business sector is viewed as very risky, and perhaps the most reliable measure of that risk is the proportion of firms that go bust, then financing the business almost exclusively with borrowings is tantamount to gambling.

Debt has to be serviced whatever your business performance, so in any risky, volatile marketplace, you stand a good chance of being caught out one day.

If your business risks are low, profits are probably relatively low too. High profits and low risks always attract a flood of competitors, reducing your profits to levels that ultimately reflect the riskiness of your business sector. Because venture capitalists and shareholders generally look for better returns than they can get by lending the money, they'll be disappointed in an investment in a low-risk, low-return business. So if they're wise they don't get involved in the first place, or if they do they don't put any more money in later.

Examining your own finances

Obviously, the first place to start looking for money to finance your business is in your own pockets. You may not have much in ready cash, but you may have assets that you can turn into cash or use to support borrowing.

Start by totalling your assets and liabilities. The chances are that your most valuable *assets* are your house, your car and any life assurance or pension policies you may have. Your *liabilities* are the debts you owe. The difference between your assets and your liabilities, assuming that you have more of the former than the latter, is your *net worth*. That, in effect, is the maximum security you can offer anyone outside the business from whom you want to raise money.

The big questions are, what is your appetite for risk and how certain are you that your business will be successful? The more of your own money you can put into your business at the outset, the more you're truly running your own business in your own way. The more outside money you have to raise, the more power and perhaps value you have to share with others.

Now you have a simple piece of arithmetic to do. How much money do you need to finance your business start-up, as shown in your worst-case scenario cash-flow forecast? How much of your own money are you willing and able to put into your business? The difference is the sum you're looking to outside financiers to back you with.

If that sum is more than your net worth, then you're looking for investors. If it's less, then bankers may be the right people to approach.

If you do have free cash or assets that you could but won't put into your business, then you should ask yourself whether the proposition is worth pursuing. You can be absolutely certain that any outsider you approach for money will ask you to put up or shut up.

Another factor to consider in reviewing your own finances is your ongoing expenses. You have to live while getting your business up and running. So food, heat and a roof over your head are essential expenses. But perhaps a two-week long-haul summer holiday, a second car and membership of a health club aren't essentials – great while you were a hired hand and had a salary cheque each month, but an expendable luxury when you're working for yourself.

Determining the Best Source of Finance for You

Choosing which external source of finance to use is to some extent a matter of personal preference. One of your tasks in managing your business's financial affairs is to keep good lines of communication open with as many sources as possible. The other key task is to consider which is the most appropriate source for your particular requirement at any one time. I explore the main issues you need to consider in the following sections.

Considering the costs

Clearly, if a large proportion of the funds you need to start your business is going to be consumed in actually raising the money itself, then your set-up costs are going to be very high. Raising capital, especially if the amounts are relatively small (under

£500,000), is generally quite expensive. You have to pay your lawyers and accountants, and those of your investor or lender, to prepare the agreements and to conduct the due diligence examination (the business appraisal). Spending between 10 and 15 per cent of the first £500,000 you raise on set-up costs isn't unusual.

An overdraft or factoring agreement is relatively cheap to set up, usually a couple of per cent or so. However, long-term loans, leasing and hire-purchase agreements can involve some legal costs.

Sharing ownership and control

The source of your money helps determine how much ownership and control you have to give up in return. Venture capitalists generally want a large share of stock and often a large say in how the business is run. At the other end of the spectrum are providers of long-term loans, who generally leave you alone so long as you service the interest and repay the capital as agreed. You have to strike the balance that works best for you and your business.

If you don't want to share the ownership of your business with outsiders, then clearly raising equity capital isn't a good idea. Even if you recognise that owning 100 per cent of a small venture isn't as attractive as owning 40 per cent of a business ten times as large, it may not be the right moment to sell any of your shares; particularly if, in common with many business founders, long-term capital gain is one of your principal goals. If you hold on to your shares until profits are reasonably high, you realise more gain for every share sold than if you sell out in the early years or while profits are low.

Parting with shares inevitably involves some loss of control. Letting 5 per cent go may be merely a mild irritation from time to time. However, after 25 per cent has gone, outsiders can have a fair amount of say in how you run things. At that point, even relatively small groups of shareholders can find it easy to call an Extraordinary General Meeting and vote to remove you from the board. Nevertheless, while you have over 51 per cent you're in control, if only just. When you're past the 51 per cent things can get a little dangerous. Theoretically, you can be outvoted at any stage.

Some capital providers take a hands-on approach and have a view on how you should run the business.

Beating the clock

Overdrafts can be arranged in days; raising venture capital can take months. You need very different amounts of scarce management time, dependent on the financing route you take. So if speed matters, your funding options may be limited.

Venture capital providers have been known to string out negotiations long enough to see whether the bullish forecasts made in the business plan come to pass. After all, venture capital is there to help businesses grow faster than they might otherwise do, not just to keep them afloat. Don't expect a decision from a venture capital firm in under three months, whatever their brochure says. Four to six months is a more realistic timescale and nine months isn't too unusual.

Business angels can usually make investment decisions much more quickly than venture capitalists; after all, they're risking their own money. Weeks rather than months is the timescale here.

Obtaining bank finance is usually a fairly speedy process. Even large loans of £100,000 and upwards can be arranged in a few weeks. But the speed depends more on how much collateral you have to give the bank manager comfort that the bank's money is safe.

Staying flexible

As your plans change, the amount of money you need may alter during negotiations. Some sources of funds such as leasing, hire-purchase agreements and long-term loans dictate the amount that has to be agreed at the outset. If you sell shares in the company you have some fluidity during negotiations, and if you arrange an overdraft you can draw down only what you need at any one time, with the upper limit usually negotiated each year.

After you've investigated and used a source of funds, you may want to be able to use that source again as your plans unfold. Loans and hire-purchase/leasing agreements are for a specific sum and it can be difficult and expensive going back to the same source for more.

Gaining security and certainty

For most sources of money, if you comply with the agreed terms, the future is reasonably predictable – in so far as that money is concerned. The exception to this rule is an overdraft. An overdraft is technically, and often actually, repayable on demand. Overdrafts are sometimes called in at the moment you need them most.

Limiting personal liability

As a general rule, most providers of long-term loans and overdrafts look to you and other owners to provide additional security if the business assets are in any way inadequate. You may be asked to provide a personal guarantee – an asset such as your house. Only when you raise new share capital, by selling more stock in your company, do you escape increasing your personal liability. Even with the new share capital, you may be asked to provide warranties to assure new investors that you've declared everything in the company's history.

Going for Debt

You can explore borrowing from a number of possible sources in your search for outside finance. It's worth giving them all the once-over, but most people start and stop at a bank. The other major first source of money is family and friends, but many business starters feel nervous about putting family money at risk, and prefer to deal with professional financiers. *Credit unions* and *mezzanine finance* are fairly unusual sources of finance for a start-up, but finding money to start a business is a tough task, so you shouldn't completely overlook any source. (I explain these terms later in this chapter.)

Borrowing from banks

Banks are the principal, and frequently the only, source of finance for nine out of every ten new and small businesses.

Banks are usually a good starting point for almost any type of debt financing. They're also able to provide many other cash-flow and asset-backed financing products, although they're often not the only or the most appropriate provider. As well as the main clearing banks, a number of the former building societies and smaller regional banks are competing hard for small firm lending.

Hippychick

When new mother Julie Minchin discovered the Hipseat she knew she'd found a helpful product. Anything that makes carrying a baby around all day without ending up with excruciating back ache has got to be a benefit. It was only later that she realised that selling the product for the German company that made the Hipseat could launch her into business. At first Julie acted as their UK distributor but later she wanted to make some major improvements to the product. That meant finding a manufacturer to make the product especially for her business. China was the logical place to find a company flexible enough to make small quantities as well as being able to help her keep the cost of the end product competitive.

Julie funded the business, Hippychick, with a small family loan, an overdraft facility and a variety of grants secured with the help of Business Link. Now in its tenth year the company has a turnover of £3 million a year and sells 14 new and unique products aimed at the baby market. Hippychick supplies national chains such as Boots, Mothercare and Blooming Marvellous, as well as independents. It also sells via a catalogue and website, and is in the process of building a network of distributors for the branded products.

Keeping the money men happy

Most owner-managers don't give much thought to how to deal with their bank, factoring company or venture capitalist. They just jump right into their business and don't think about how they should treat these people, what their bankers can do for them and what their bankers in turn look for in a client. But with a little thought and effort, you can ensure that you get the most from your banking relationships.

Your banker, or any other source of finance, has the ability to influence the success of your business radically. Developing long-term, personal relationships with the banker is important – if you do that, when you hit the inevitable bumps in the road the banker will be there to help you.

Keep in mind when you meet your banker for the first time that you want to develop a long-term relationship with this person. The meeting should be a two-way interview. You should ask yourself: 'Is this person genuinely interested in me? Is this person trying to understand my business? Does this person understand my objectives?' If the answer to any of these is no, then find another banker.

You often hire your lawyer and accountant by the hour or job, but your banker is another matter – your banker makes money off the fees that your business generates. Your banker is usually happy to help you, and can therefore be a source of free consulting, though you do need to be a little more careful today because bankers are beginning to get wise to the idea of charging for services.

<Tip shop around for the best-buy bank just as you do for any other product or service. Check out Money Facts (http://moneyfacts.co.uk/compare/banking) or Which 4 U (www.which4u.co.uk/bank-accounts) to see who's offering the best deals.

If you import raw materials, your bank can provide you with Letters of Credit, which guarantee your suppliers payment from the bank when they present proof of satisfactory delivery. If you have a number of overseas suppliers who prefer settlement in their own currency for which you need foreign currency, cheque facilities or to buy money at a fixed exchange rate before you need it, banks can make the necessary arrangements.

Running an overdraft

The principal form of short-term bank funding is an *overdraft*. An overdraft is permission for you to use some of the bank's money when you don't have enough of your own. The permission is usually agreed annually, but can be withdrawn at any time. A little over a quarter of all bank finance for small firms is in the form of an overdraft. The overdraft was originally designed to cover the time between having to pay for raw materials to manufacture finished goods and selling those goods. The size of an overdraft is usually limited to a modest proportion of the amount of money that your customers owe you and the value of your finished goods stock. The bank sees those items as assets, which in the last resort it can use to get its money back.

Starting out in a cleaning business, for example, you need sufficient funds initially to buy the mop and bucket. Three months into the contract you've paid for these and so getting a five-year bank loan to cover this expenditure is pointless, because within a year you'll have cash in the bank.

However, if your overdraft doesn't get out of the red at any stage during the year, you need to re-examine your financing. All too often companies utilise an overdraft to acquire long-term assets, and that overdraft never seems to disappear, eventually constraining the business.

The attraction of overdrafts is that they're very easy to arrange, except in the most unusual of circumstances such as during a global credit crunch. Also they take little time to set up. But their inherent weakness is that the keywords in the arrangement document are 'repayable on demand', which leaves the bank free to make and change the rules as it sees fit. (This term is under review and some banks may remove the term from the arrangement.) With other forms of borrowing, as long as you stick to the terms and conditions, the loan is yours for the duration; not so with overdrafts.

Seeing the five Cs

Bankers like to speak of the five Cs of credit analysis, factors they look at when they evaluate a loan request. When applying to a bank for a loan, prepare to address the following points:

- **Capacity:** This is a prediction of the borrower's ability to repay the loan. For a new business, bankers look at the business plan. For an existing business, bankers consider financial statements and industry trends.

- **Capital:** Bankers scrutinise a borrower's net worth, the amount by which assets exceed debts.

- **Character:** Bankers lend money to borrowers who appear honest and who have a good credit history. Before you apply for a loan, it makes sense to obtain a copy of your credit report and clean up any problems.

- **Collateral:** Bankers generally want a borrower to pledge an asset that can be sold to pay off the loan if the borrower lacks funds.

- **Conditions**: Whether bankers give a loan can be influenced by the current economic climate as well as by the amount requested.

Banks also use CAMPARI, which stands for Character, Ability, Means, Purpose, Amount, Repayment, Insurance. You can find out more about this alternative system on this website: www.bytestart.co.uk/content/finance/funding/business-bank-loan.shtml.

Taking on a term loan

If you’re starting up a manufacturing business, you’ll be buying machinery to last probably five years, designing your logo and buying stationery, paying the deposit on leasehold premises, buying a vehicle and investing funds in winning a long-term contract. Because you expect the profits on this to flow over a number of years, they need to be financed over a similarly long period, either through a bank loan or by inviting someone to invest in shares in the company – in other words, a long-term commitment.

Term loans, as these long-term borrowings are generally known, are funds provided by a bank for a number of years. The interest can be either variable – changing with general interest rates – or fixed for a number of years ahead. In some cases you may be able to move between having a fixed interest rate and a variable one at certain intervals. You may even be able to have a moratorium (break) on interest payments for a short period, to give the business some breathing space. Provided that you meet the conditions of the loan in such matters as repayment, interest and security cover, the money is available for the period of the loan. Unlike having an overdraft, the bank can’t pull the rug from under you if your circumstances (or the local manager) change.

Going with a loan guarantee

Banks operate loan guarantees at the instigation of governments in the UK, and in Australia, the US and elsewhere. These schemes guarantee loans from banks and other financial institutions for small businesses with viable business proposals that have tried and failed to obtain a conventional loan because of a lack of security.

Currently called the Enterprise Finance Guarantee Scheme, these government-backed loans are available for periods between two and ten years on sums from £5,000 to £2.5 million. The government guarantees 70–90 per cent of the loan. In return for the guarantee, the borrower pays a premium of 1–2 per cent per year on the outstanding amount of the loan. The commercial aspects of the loan are matters between the borrower and the lender.

You can find out more about the details of the scheme on the Business Link website (www.businesslink.gov.uk; go to Finance and Grants; Finance Options; Borrowing; Loans and Overdrafts; and then Enterprise Finance Guarantee).

Cashflow Acceleration, an independent finance broker and a member of the Federation of Small Businesses, provides a free independent quotation search service for customers looking for commercial finance. At www.cashflow-acceleration.co.uk (go to Services and then Enterprise Finance Guarantee) you can see whether a bank may be prepared to lend under the scheme to your business.

TRUE STORY

Destination London

Rachel Lowe, a 29-year-old single mother with two children, came up with her winning business idea while working part time as a taxi driver in Portsmouth. She invented a game involving players throwing a dice to move taxi pieces around a board collecting fares to travel to famous destinations while aiming to get back to the taxi rank before they ran out of fuel. Being able to run the business from home meant Rachel could spend more time with her children and still be a breadwinner.

But despite having a business plan written up when she entered a local business competition, she had serious hurdles to cross before she could get started. With a deal from Hamleys, the London toyshop, in the bag and a manufacturer and distributor lined up, all that was missing was a modest amount of additional funding to help with marketing and stock. She pitched her proposal to the BBC's Dragons Den and was given a thorough roasting. To say the dragons weren't enthusiastic would be a serious understatement. They reckoned Monopoly would wipe the floor with her. Bowed but far from beaten Rachel then turned to South Coast Money Line, a Community Development Finance Institution and part of the Portsmouth Area Regeneration Trust Group (www.part.org.uk). With a loan from them she propelled her game – Destination London – into the top ten best-selling games, even beating Monopoly! A deal with Debenhams to stock regional versions of the game and signing up to produce Harry Potter and Disney versions left her with a business worth £2 million, at a conservative estimate.

Grabbing some cash locally

Many communities, particularly those operating in rundown areas in need of regeneration, have a facility to lend or even invest in businesses that could bring employment to the area. The nearby sidebar 'Destination London offers one such example. Funding from these sources could be for anything from start-up, right through to expansion or in some cases even rescue finance to help prevent a business from folding, shedding a large number of jobs or relocating to a more benign business environment.

Financing cash flow

When your business is trading two other sources of finance open up that can smooth out cash-flow troughs when dealing with business customers. Factoring and invoice discounting are both methods of funding sales after you've submitted an invoice.

Factors provide three related services:

- Immediate finance of up to 80 per cent of invoiced sales, with the balance (minus administration and finance charges) payable after a set period or when the invoice is paid
- Managing the sales ledger, including sending out invoices and ensuring they're paid
- Advising on credit risk and insuring clients against bad debts

This type of finance is provided against the security of trade debts (the amount of money customers owe you). Normally, when you raise an invoice you send a copy to the factor, who then funds up to 85 per cent against the invoice in advance of the customer paying. The remainder becomes payable either on a maturity date or when the customer pays. Because the invoice is assigned to the factor, payment by the customer is direct to the factor.

Invoice discounting operates in a similar way, except the seller retains control of its debtors and is responsible for collecting the money.

These forms of finance are directly related to sales levels and can be particularly helpful during growth spurts.

The Factors and Discounters Association (www.thefda.org.uk/public/membersList.asp) provides a list of over 40 members on its website, which has a search facility to help you define which organisations are best placed to meet your individual business requirements.

Getting physical

You can usually finance assets such as vehicles, computers, office equipment and the like either by leasing them or buying them on hire purchase, leaving your other funds free to cover less tangible expenses such as advertising or living expenses. You can use a lease to take the risk out of purchasing an asset that becomes obsolete or for taking account of repairs and maintenance costs. In return for this 'certainty' you pay a fee that's added to the monthly or quarterly charge. However, knowing the exact cost of purchasing and using an asset can be attractive and worth paying for. Hire purchase differs from leasing in that you have the option eventually to become the owner of the asset after a series of payments. Important tax implications apply to using these types of finance and you should discuss them with your accountant (I cover finding an accountant in Chapter 13).

The Finance and Leasing Association Web site (www.fla.org.uk/asset/members) gives more information on the different products on offer to finance assets and has a directory of members and their contact details. You can also use the calculator at www.leasing.co.uk/leasecalculator to get some idea of the monthly repayments for different types of assets (such as software, furniture or cars) over different time periods.

Uniting with a credit union

If you don't like the terms on offer from the *high-street banks*, as the major banks are often known, you may consider forming your own bank. The idea isn't as crazy as it sounds. Credit unions formed by groups of small businesspeople, both in business and aspiring to start up, have been around for decades in the UK, US and elsewhere. They're an attractive option for people on low incomes, and provide a cheap and convenient alternative to banks. Some self-employed people such as taxi drivers have also formed credit unions. They can then apply for loans to meet unexpected capital expenditure either for repairs, refurbishments or technical upgrading.

Established credit unions usually require you to have a particular trade, have paid money in for a number of months or years and have a maximum loan amount limited to the types of assets people in their trade are likely to need.

Credit union usage in the UK has more than doubled in the past five years. Some 40, 258 Credit unions operate in 79 countries, enabling 118 million members to access affordable financial services. The Association of British Credit Unions (www.abcul.org) offers information and a directory of providers.

Borrowing from family and friends

Those close to you are often willing to lend you money or invest in your business. This helps you avoid the problem of pleading your case to outsiders and enduring extra paperwork and bureaucratic delays. Help from friends, relatives and business associates can be especially valuable if you've been through bankruptcy or had other credit problems that make borrowing from a commercial lender difficult or impossible.

Involving friends and family in your business brings a range of extra potential benefits – but also costs and risks that aren't a feature of most other types of finance. You need to decide whether these are acceptable.

Some advantages of borrowing money from people you know well are that they may charge you a lower interest rate, you may be able to delay paying back money until you're more established and you may have more flexibility if you get into a jam. But after you agree to the loan terms, you have the same legal obligations as with a bank or any other source of finance.

Borrowing money from relatives and friends can have a major disadvantage. If your business does poorly and those close to you end up losing money, you may damage your personal relationships. So in dealing with friends, relatives and business associates be careful to establish clearly the terms of the deal and put them in writing, and also to make an extra effort to explain the risks. In short, your job is to make sure that your helpful friend or relative doesn't suffer true hardship if you're unable to meet your financial commitments.

When raising money from family and friends, follow these guidelines.

- Do agree proper terms for the loan or investment.
- Do put the agreement in writing and if it involves a limited partnership, share transaction or guarantee, have a legal agreement drawn up.
- Do make an extra effort to explain the risks of the business and the possible downside implications to their money.
- Do make sure when raising money from parents that other siblings are compensated in some way, perhaps via a will.
- Do make sure you want to run a family business before raising money from them. It's not the same as running

your own business.

- Don't borrow from people on fixed incomes.
- Don't borrow from people who can't afford to lose their investment.
- Don't make the possible rewards sound more attractive than you would, say, to a bank.
- Don't offer jobs in your business to anyone providing money unless the person is best for the job.
- Don't change the normal pattern of social contact with family and friends after they've put up the money.

Sharing Out the Spoils

If your business is particularly risky, requires a lot of up-front finance or involves new technology, then you usually have to consider selling a proportion of your business's shares to outside investors.

However, if your business plan doesn't show profit returns in excess of 30 per cent per annum for the next three to five years (see Chapter 13 for more on profit ratios) and you aren't prepared to part with upwards of 15 per cent of your business, then equity finance probably isn't for you.

A number of different types of investor may be prepared to put up the funds if the returns are good enough. I talk about each type in the following sections.

Benefiting by business angels

One source of equity or risk capital is private individuals, with their own funds and perhaps some knowledge of your type of business, who are willing to invest in your company in return for a share in the business.

> Such investors have been christened *business angels*, a term first coined to describe private wealthy individuals who backed theatrical productions, usually a play on Broadway or in London's West End.

By their very nature such investments are highly speculative in nature. The angel typically has a personal interest in the venture and may want to play some role in the company – often an angel is determined to have some involvement beyond merely signing a cheque.

Business angels are informal suppliers of risk capital to new and growing businesses, often taking a hand at a stage when no one else is prepared to take the chance; a sort of investor of last resort. But although they often lose their shirts, business angels sometimes make serious money. The angel who backed software company Sage with £10,000 in its first round of £250,000 financing saw his stake rise to £40 million, and Ian McGlinn, the former garage owner who advanced Anita Roddick the £4,000 she needed to open a second shop in return for about 25 per cent of her company's shares, eventually wound up with a couple of hundred million pounds from his stake in The Body Shop.

In the UK and the US hundreds of networks operate with tens of thousands of business angels who are prepared to put several billion pounds each year into new or small businesses. One estimate is that the UK has approximately 18,000 business angels and that they annually invest in the region of £500 million.

Two organisations that can put you in contact with a business angel are:

- The British Business Angels Association (BBAA; website: www.bbaa.org.uk).
- Angel Investment Network (www.angelinvestmentnetwork.co.uk), which operates a service matching entrepreneurs to angels. Their website also has a number of useful tools to help you get investor ready.

Alternatively, you could apply to appear on the BBC's business reality show *Dragon's Den* (www.bbc.co.uk/dragonsden) and put your proposition face to face to 5 angels and 5 million television viewers.

Going for venture capital

Venture capital is a means of financing the start-up, development, expansion or the purchase of a company. The venture capitalist acquires a share of the company in return for providing the requisite funding. Venture capital firms often work in conjunction with other providers of finance in putting together a total funding package for a business.

Venture capital providers invest other people's money, often from pension funds. They're likely to be interested in investing a large sum of money for a large stake in a company.

Venture capital is a medium- to long-term investment of not just money but of time and effort. The venture capital firm's aim is to enable growth companies to develop into the major businesses of tomorrow. Before investing, a venture capital provider goes through *due diligence*, a process that involves a thorough examination of both the business and its owners. Accountants and lawyers subject you and your business plan to detailed scrutiny. You and your directors are required to warrant that you've provided *all* relevant information, under pain of financial penalties.

In general venture capitalists expect their investment to pay off within seven years. But they're hardened realists. Two in every ten investments they make are total write-offs, and six perform averagely well at best. So the one star in every ten investments they make has to cover a lot of duds. Venture capitalists have a target rate of return of 30 per cent plus, to cover this poor success rate.

Raising venture capital isn't a cheap option. The arrangement costs almost always run to six figures. The cost of the due diligence process is borne by the firm raising the money, but is paid out of the money raised, if that's any consolation. Raising venture capital isn't quick either. Six months isn't unusual and over a year has been known. Every venture capitalise has a deal done in six weeks in their portfolio, but that truly is the exception.

Venture capital providers want to exit from their investment at some stage. Their preferred route is via a public offering, taking your company onto the stock market, but a trade sale to another, usually larger, business in a related line of work is more usual.

New venture capital funds are coming on stream all the time and they too are looking for a gap in the market.

The British Venture Capital Association (www.bvca.co.uk) and the European Venture Capital Association (www.evca.com) both have online directories giving details of hundreds of venture capital providers. VFinance (www.vfinance.com), a global financial services company specialising in high-growth opportunities, has a directory of 1,541 venture capital firms and over 23,000 business angels. Its website also contains a useful business plan template. (See Chapter 6 for more on business planning.)

Karen Darby left school at 16 with just one GCSE. While working in a call centre in 2002 she hit on the idea of helping people find the cheapest gas, electricity and telephone companies and providing a user-friendly way to switch suppliers for free. She pitched her business proposition to Bridges Community Ventures, a venture capital firm, and raised £300,000. Three years down the road she sold her company, SimplySwitch, to Daily Mail and General Trust, leaving Karen £6 million richer.

Looking to corporate venturing

Alongside the venture capital firms are 200 or so other businesses that have a hand in the risk capital business, without it necessarily being their main line of business. For the most part these are firms with an interest in the Internet or high technology that want an inside track to new developments. Their own research and development operations have slowed down and become less and less entrepreneurial as they've grown bigger. So they need to look outside for new inspiration.

Even successful firms invest hundreds of millions of dollars each year in scores of other small businesses. Sometimes, if the company looks a particularly good fit, they buy the whole business. Apple, for example, while keeping its management team focused on the core business, has a $12 million stake in

Akamai Technologies, whose software tries to keep the web running smoothly even under unusual traffic demands.

Not only high-tech firms go in for corporate venturing. Any firm whose arteries are hardening a bit is on the look-out for new blood. McDonald's, for example – hardly a business in the forefront of the technological revolution – has stakes in over a dozen ventures. It once had a 35 per cent stake in Pret a Manger, but when it decided that the Pret model didn't fit well with the McDonald's business it offloaded its stake to Bridgepoint for £345 million – four times its initial stake; a good result for both parties.

Innocent

In the summer of 1998, when Richard Reed, Adam Balon and Jon Wright had developed their first smoothie recipes but were still nervous about giving up their jobs, they bought £500 worth of fruit, turned it into smoothies and sold them from a stall at a London music festival. They put up a sign saying 'Do you think we should give up our jobs to make these smoothies?' next to bins saying 'YES' and 'NO', inviting people to put the empty bottle in the appropriate bin. At the end of the weekend the 'YES' bin was full, so they went to work the next day and resigned. The rest, as they say, is history. Virtually a household name, Innocent Drinks has experienced a decade of rapid growth.

But the business stalled in 2008, with sales slipping back and their European expansion soaking up cash at a rapid rate. The founders, average age 28, decided that they needed some heavy-weight advice and talked to Charles Dunstone, Carphone Warehouse founder, and Mervyn Davies, chairman of Standard Chartered. The strong advice was to get an investor with deep pockets and ideally something else to bring to the party to augment the youthful enthusiasm of the founders. They launched their search for an investor the day that Lehman Brothers filed for bankruptcy. In April 2009 the Innocent team accepted Coca-Cola as a minority investor in their business, paying £30 million for a stake of between 10–20 per cent. They chose Coca-Cola because as well as providing the funds, the company can help get Innocent products out to more people in more places. They'll also be able to learn a lot from Coco-Cola, who have been in business for over 120 years.

When Alex Cassie was casting around for cash to get his new business making parts for car companies such as Aston Martin, he was steered to an apparently unlikely source, Michelin, the French tyre firm. Since 2003 Michelin has operated a scheme pledged to put £3 million into small firms near its British plants. Michelin put £20,000 into Cassie's business, which within four years employed 68 people with an annual turnover of £5 million.

Understanding due diligenceUsually, after a private equity firm signs a letter of intent to provide capital and you accept, they conduct a *due diligence* investigation of both the management and the company. During this period the private equity firm has access to all financial and other records, facilities and employees to investigate before finalising the deal. The material the firm examines includes copies of all leases, contracts and loan agreements in addition to copious financial records and statements. The firm wants to see any management reports, such as sales reports, inventory records, detailed lists of assets, facility maintenance records, aged receivables and payables reports, employee organisation charts, payroll and benefits records, customer records and marketing materials. They want to know about any pending litigation, tax audits or insurance disputes. Depending on the nature of the business, they might also consider getting an environmental audit and an insurance check-up.

The sting in the due diligence tail is that the current owners of the business are required to personally warrant that everything they've said or revealed is both true and complete. In the event that proves not to be so, owners will be personally liable to the extent of any loss incurred by those buying the shares.

Finding Free Money

Sometimes, if you're very lucky or very smart, you can get some of the money you need for free. The following sections tell you how to cash in on government grants and how winning a contest can earn you lots of lovely loot.

Getting a grant

Unlike debt, which you have to repay, or equity, which has to earn a return for the investors, grants and awards from the government or the European Union are often not refundable. So, although they're frequently hard to get, grants can be particularly valuable. Almost every country has incentives to encourage entrepreneurs to invest in particular locations or industries. The US, for example, has an allowance of Green Cards (work and residence permits) for up to several hundred immigrants each year who are prepared to put up sufficient funds to start up a substantial business in the country.

In the UK, if you're involved in the development of a new technology you may be eligible for a grant for research and development. Under the scheme you can claim 60 per cent of eligible project costs up to a maximum grant of £75,000 on research projects; 35 per cent of costs up to £200,000 on development projects; 35 per cent of costs up to £500,000 on exceptional development projects; and 50 per cent of costs up to a maximum grant of £20,000 on micro projects. Business Link (www.businesslink.gov.uk) can give full details of the grants.

Support for business comes in a very wide variety of forms. The most obvious is the direct (cash) grant, but other forms of assistance are also available including free or subsidised consultancy, which could help you with market research, staff development or identifying business opportunities, or with access to valuable resources such as research facilities.

Grants often come with strings attached including you needing to locate in a specific area, take on employees or find matching funding from another source.

Though several grant schemes operate across the whole of the UK and are available to all businesses that satisfy the outline criteria, myriad schemes exist that are administered locally. Thus the location of your business can be absolutely crucial, and funding may strongly depend on the area into which you intend to grow or develop. Additionally, extra grants may well be available to a business investing in an area of social deprivation, particularly if it involves sustainable job creation.

Keep yourself informed about which grants are available. Grants are constantly being introduced and withdrawn, but no system lets you know about them automatically. The Business Link (www.businesslink.gov.uk; go to Finance and Grants) and Grants Online (www.grantsonline.org.uk) websites can help you find out about grants.

Winning money

If you enjoy publicity and like a challenge then you can look out for a business competition to enter. Like government grants, business competitions are ubiquitous and, like national lotteries, they're something of a hit-or-miss affair. But one thing is certain: if you don't enter you can't win.

More than 100 annual awards take place in the UK alone, aimed at new or small businesses, and are mostly sponsored by banks, major accountancy bodies, chambers of commerce, local or national newspapers, business magazines and the trade press. Government departments may also have competitions for promoting their initiatives for exporting, innovation, job creation and so forth. The nature and amount of the awards change from year to year, as do the sponsors. But looking in the national and local press, particularly the small business sections of *The Times*, *Daily Telegraph*, *Daily Mail* and *The Guardian*, and on the Internet, should put you in touch with a competition organiser. Money awards constitute 40 per cent of the main competition prizes. For the most part, these cash sums are less than £5,000. However, a few do exceed £10,000 and one British award is for £50,000.

Business Match (www.businessmatch.org.uk/576.asp), the Design Council (www.designcouncil.org.uk/our-work/investment), the National Business Awards (www.nationalbusinessawards.co.uk) and the Growing Business Awards (http://gba.realbusiness.co.uk) are all websites that can help you find out about competitions.

Business Link has a Business Awards Finder (http://online.businesslink.gov.uk/bdotg/action/bafSearch). Just put in your postcode and business sector and the site provides details of any award you could be eligible to apply for. The website warns that not all the awards it flags up involve cash, but the free publicity should be more than worthwhile.

Chapter 9

Considering Your Mission

In This Chapter

- Pinpointing your concept
- Stating your mission
- Looking at vision
- Tending to goals and objectives

To be successful in the marketplace, you need to have a clear picture of exactly what you want to do and who you're doing it for. In other words, you need a vision and a mission.

Say you want to start your own airline. That idea in itself doesn't make a business. What destinations will you fly to, what type of planes will you use, how will you sell your tickets and who will you sell them to are all burning questions that set what are known as the *parameters* of your business. You can think of this as a process that narrows down the big universe that starting your own airline begins with, until you focus down on flying tourists to and from New York, which is where Virgin began.

Defining the parameters of your vision involves getting to know more about your future customers and more about what you plan to do to woo and win them. Every business needs a winning concept, a clear mission, an inspirational vision and achievable objectives and goals. No rocket science in that.

In this chapter I tell you how to refine your vision and compose a mission statement that you can adjust to suit your goals throughout the life of your business.

Developing Your Concept

When you know the basic concept of what you're selling and to whom, you should refine that by examining the features of the product (or service) and the benefits that customers get when they purchase. *Features* are what a product has or is, and *benefits* are what the product (or service) does for the customer. For example, cameras and even film or memory sticks aren't the end product that customers want: they're looking for good pictures. Finally, include proof that you can deliver these benefits.

You need to decide your business concept, and you really need to get a good handle on it before you can go much further with your business plans.

Composing Your Mission Statement

A *mission statement* explains in clear, concise terms what the business does. To devise a worthy mission statement, focus your attention on your strengths and the value you provide to your customers.

Your mission should be narrow enough to give direction and guidance to everyone in the business. This concentration is the key to business success because only by focusing on specific needs can a small business differentiate itself from its larger competitors. Nothing kills off a business faster than trying to do too many different things too soon. Also, your mission should address a large enough market to allow your business to grow and realise its potential.

Thinking through your mission

Mission statements mustn't become too bland or too general. Anyone reading the statement should be able to tell what business your company is in, what it aims to achieve in the next three years and how it aims to do so.

Your mission statement should explain what business you're in or plan to enter. It should include some or all of the following:

- Market/customer needs: who are we satisfying/delighting?
- What product/service are we offering that meets those needs?
- What are our capabilities, both particular skills and knowledge, and resources?
- What market opportunities exist for our product or service, and what threats exist from competitors (and others)?
- What do we want to achieve both now and in the future?

Above all, mission statements should be realistic, achievable and brief. You certainly don't need to take a long weekend in a country hotel with key staff and management consultants poring over flip charts to develop your mission statement. If you can't distil the essence of what you plan to do in a simple, direct sentence or two, then you'd better hold back on the launch party and definitely don’t order champagne and balloons.

Run through the following checklist periodically to make sure that your mission statement is still on track:

- Write down your company’s mission statement from memory. Have your oldest employee and your newest employee do the same, and then compare the three. Use the differences to refine either the mission statement or employee training.
- How long ago did you write your mission statement? You may need to look at a mission written before you carried out lots of market research or sold anything much to see whether it’s still valid.
- Does the mission statement still accurately reflect what you do?
- Would this mission statement stand out in a crowd?
- Could a 14-year-old understand it? (That is the standard of the average tabloid reader.)
- Does your mission statement provide a clear guide to action?
- Does it tell you what businesses you’re *not* in?

Ultimately, your mission statement reflects the unique quality of your business that makes people want to buy from you. That uniqueness may be contained in the product or service, but it’s more likely to be woven into the fabric of the way you do business. Try telephoning any three car hire firms, or walking into three restaurants. The chances are that it's not their products but their people and systems that make them stand out.

What the mission statement does is get everyone pulling hard in the same direction. The direction may change slightly over time, but everyone will still be pulling the same way and the company will move forward, rather than stand still or decline.

You can see a cross section of example mission statements at www.leadership-tools.com/example-of-mission-statement.html.

Seeing the Vision Thing

Vision isn't the same as mission. You can think of *mission* as providing direction for the medium term along a line that most people can follow. *Vision* is about stretching the organisation's reach beyond its grasp. Generally, few people concerned with the company can now see how the vision is to be achieved, but all concerned agree that it would be great if it could be. When your vision becomes reality it may be time for a new challenge, or perhaps even a new business.

Microsoft founder Bill Gates had a vision of a computer in every home at a time when few offices had one. As a mission statement 15 years ago this may have raised a wry smile. After all, only a few decades before IBM had estimated the entire world demand for its computers as seven! Now, Gates's vision has been all but reached.

You need to create the vision with the people who work with you in order to be sure of their wholehearted commitment. You can't get that commitment if the only people who buy into the vision are you, your partner and the management consultant who sold it to you.

As with the mission, only when everyone knows and shares the business's vision is it likely to be achieved. All parts of the organisation are so connected to each other, to the market and to the customer in such a complex series of relationships that the management team can't hope to achieve anything much without everyone's input. Rather, in the way that markets work better with perfect information, businesses work better when everyone knows and believes in the goal.

Setting Objectives and Goals

Missions and visions are vital, but they aren't much good without clear objectives, which are the major measurable tasks for the business and operating goals for individuals. For example, you need some idea of how big you want the business to be – in other words, what your share of the market is likely to be.

Forecasting sales is certainly not easy, especially before you've even started trading, but if you don't set a goal at the start and instead just wait to see how things develop, then one of two problems is likely to occur. Either you don't sell enough to cover your fixed costs and so lose money and perhaps go out of business, or you sell too much and run out of cash while you wait for your customers to pay up; in other words, you over-trade.

Obviously, before you can set a market share and sales objective you need to know the size of your market. (See Chapter 4 for information on how to research the market.)

The size you want your business to be is more a matter of judgement than forecast. You make a judgement tempered by the resources you have available to achieve those objectives and by some idea of what is reasonable and achievable and what isn't. The amount of money you can persuade outsiders to pump into your business also limits your ambition.

TIP

Set near-term objectives covering the next 18 months or so, and longer-term objectives covering up to three or so years further on.

REMEMBER

You can set objectives in any number of areas, but the most vital areas are *profits*, the money you have left after everyone has been paid; *margins*, the profit made per item sold; *return on capital employed*, the profit made for every pound invested and *value added per employee*, the profit made per person employed, which I look at in Chapters 13; and *sales volume and value in pounds* and your *percentage share of the market*, which I look at in Chapter 17.

You also need to ensure that any objectives set meet these criteria:

- **Accepted:** This means that whoever you set a goal for must commit to the task. Silence isn't a sufficient response. So, for example, sales staff should sign off acceptance of targets and production staff should confirm that they accept output goals.
- **Achievable:** If a goal is way beyond any reasonable chance of being achieved, when you fail to get there all concerned, yourself included, are going to be demotivated.

- **Allocated:** You should leave no objective hanging, without some named person or persons being assigned the task of achieving all or part of the task in question.
- **Challenging:** Objectives need to stretch but not break.
- **Measurable:** There's an old saying: 'What gets measured gets done.' Certainly, if you can't measure something, setting goals in that area is pointless.
- **Time-scaled:** Not great English, but an objective without a date by which it is to be achieved is meaningless. Saying you must get sales of £100,000 a month may be challenging if you're in your first month in business, but altogether too laid-back for year five.

Chapter 10

Marketing Your Wares

In This Chapter

- Understanding the marketing mix and how to use it
- Deciding the advertising message
- Choosing the media
- Reviewing selling options

Entering the market with your product or service involves deciding on what mix of marketing ingredients to use. In cooking, the same ingredients used in different ways can result in very different products. The same is true in business, where the ‘ingredients’ are product (or service), price, place and promotion. A change in the way you put these elements together can produce an offering tailored to meet the needs of a specific market. For example, a hardback book isn’t much more expensive to produce than a paperback. However, with a bit of clever publicity, bringing the hardback out a few months before the paperback edition and a higher price tag, the publisher can create an air of exclusivity that satisfies a particular group of customers.

Making Up the Marketing Mix

The key to successful promotion lies in knowing exactly what you want people to do. A few elements can make or break the successful marketing of your business. The elements you need to consider that go to make up the marketing mix are:

- *Place* is a general term to cover everything from where you locate your business to how you get your product or service to market. Poor distribution often explains sluggish sales growth. If your type of product gets to market through several channels but you only use one of them, then no amount of price changes or extra promotion makes much difference.
- *Pricing* strategies can range from charging what the market may bear, right through to *marginal cost* (just enough to cover direct costs and a small contribution to overheads). Knowing your costs is important, but this is only one element in the pricing decision. You also have to take account of the marketplace, your competition and your product position (for example, if you offer a luxury item, your place in the market is different to that of someone who sells necessities).
- The *product or service* is what people use, but what they buy are the underlying benefits it confers on them. For example, when someone buys a camera she's not really considering whether it's SLR or digital, what lens it has, even what film it takes in the case of more traditional snappers – these end products aren't what customers want, what she's looking for is good pictures.
- *Promotion* is the means by which you will tell your market(s) about your products or services. This includes such elements as your website, leaflets, advertising and even basic items such as business cards and letterheads.

Defining Your Product or Service Parameters

To be successful in any marketplace, you need to have a clear picture of exactly what you want to do and for whom you're doing it. In other words, you need a vision and a mission. (Chapter 9 offers advice on developing your mission statement.)

To market your product effectively, you have to make decisions about factors such as product range and depth before you're ready to enter the market. Having decided to open a corner shop, for example, you still have to decide whether to focus on food only, or to carry household items and perhaps newspapers and flowers too. You also need to decide whether to carry more than one brand and size of each product.

If the key advantages of your corner shop are its location, opening hours, delivery service and friendly staff, all at competitive prices, then perhaps you don't need a wide or deep product range.

Using Advertising to Tell Your Story

You can't be confident that your customers share your zeal for your business proposition, so you need to convince them that they need what you're offering. The way to do this is to tell potential customers about what you're selling by advertising your wares.

The skill of advertising lies in reducing the global population to your target audience and reaching as many of them as you can at an economic cost. You first analyse the benefits or virtues of your product, isolate the features and translate these into customer benefits. Who has a need for your product? Define exactly who your potential customers are.

Question all the time. Then the advertising process is to set objectives for your campaign, decide on a budget, design the message, pick the medium to reach your target audience and determine how you're going to evaluate the success of your advertising.

When you understand the basics, which I go through in the following sections, you should also be able to analyse advertisements better, break them down into their elements and avoid the all too common mistakes that advertisers make every day.

> Advertising by itself doesn't sell. It doesn't shift a bad product (or at least not more than once) or create new markets. Sales literature, order forms, a sales force, stocks, distributors and a strategy must back up your advertising.

Considering the customer's point of view

People buy a product or service for what it can do for them. Customers look for the benefits. As the seller, your mission is to answer the question 'What's in it for me?' from your potential customer's point of view.

Every time you compose a sales letter, write an advertisement or plan a trade show, you must get to the heart of the matter. Why should customers purchase your product or service? What benefit may it bring them?

You need to view all your marketing efforts from the prospect's point of view, not just your own. When you know what you're selling and to whom, you can match the features of the product (or service) to the benefits the customers can get when they purchase. A *feature* is what a product has or is, and *benefits* are what the product does for the customer. Finally, include proof that the product or service can deliver these benefits. Table 10-1 shows an analysis of features, benefits and proofs.

Table 10-1 Listing Features and Benefits

Feature	*Benefit*	*Proof*
We use a unique hardening process for our machine	Our tools last longer and that saves you money.	We have a patent on the process; independent tests carried out by the Cambridge Institute of Technology show our product lasts longest.
Our shops stay open later than others in the area.	You get more choice when to shop.	Come and see.
Our computer system is fault tolerant using parallel processing.	You have no downtime for either defects or system expansion.	Our written specification guarantees this – come and talk to satisfied customers operating in your field.

You can employ this format to examine the features, benefits and proofs for your own products or services and use the information to devise your ads. Remember, the customer pays for the benefits and the seller for the features. So the benefits provide the copy for most of your future advertising and promotional efforts.

Try this out on your business idea. Keep at it until you really have a good handle on what makes your customers tick. To make the process work best, you need to talk to some real prospective customers in your target market.

Making an exhibition of yourself

One way to gather useful market research data on customers and competitors is to attend exhibitions. This is also a useful way of seeing whether a demand for what you have to offer is likely to exist, because hundreds of key decision makers are gathered in one place for you to make a pitch to.

Equinox, a designer furniture company, took part in a national exhibition at London's Earls Court while on an enterprise programme at Cranfield Business School. A grant paid for half the cost of its £1,200 stand and the £5,000 of firm orders it received more than covered the rest of the cost. More importantly, the founder felt more confident in his product and he took away 40 contacts to follow up later.

You can find out when exhibitions relevant to your business take place in the UK by searching Exhibitions UK (www.exhibitions.co.uk), the official website for the British exhibition industry, sponsored by UK Trade & Investment, the government organisation responsible for all trade promotion and development work. If you want to exhibit or attend a show overseas, TSNN (www.tsnn.com), which calls itself 'The Ultimate Trade Show Resource', operates a widely consulted event database containing data on more than 15,000 trade shows, exhibitions, public events and conferences worldwide. You need to register (free) for full access to the database.

Business Link, the British government's help agency for small businesses, has a comprehensive guide to getting the best out of exhibitions (go to www.businesslink.gov.uk, then select Sales and Marketing, Marketing and finally Trade Shows and Exhibitions). See Chapter 8 for information on finding a grant to help pay for attending exhibitions at home and abroad.

Setting advertising objectives

You're wasting your time advertising your product or service unless it leads to the opportunity for a sale in a significant number of instances. Ask yourself what potential customers have to do to enable you to make these sales. Do you want them to visit your showroom, phone you, write to your office, return a card or send an order in the post? Do you expect them to order now, or to remember you at some future date when they have a need for your services?

The more specifically you identify the response you want, the better you can tailor your promotional effort to achieve your objective, and the more clearly you can assess the effectiveness of your promotion.

The more general your advertising objective is – for example to 'improve your image' or 'to keep your name in front of the public' – the more likely it is to be an ineffective way of spending your money.

Deciding the budget

People commonly use two methods to calculate advertising budget numbers:

- **What can we afford?** This approach accepts that cash is usually a scarce commodity and advertising has to take its place alongside a range of competing demands.
- **Cost/benefit:** This approach comes into its own when you have clear and specific promotional goals. If you have spare capacity in your factory or want to sell more out of your shop, you can work out how much it costs you to increase your production and sales, and how

much you may benefit from those extra sales. You then figure out how much advertising money it takes to get you the extra business.

Suppose you expect a £1,000 advertisement to generate 100 enquiries for your product. If your experience tells you that on average 10 per cent of enquiries result in orders, and your profit margin is £200 per product, then you can expect an extra £2,000 profit. That benefit is much greater than the £1,000 cost of the advertisement, so it seems a worthwhile investment.

In practice, you should use both these methods to decide how much to spend on promoting your products.

Defining the message

To define your message, you must look at your business and its products from the customer's standpoint and be able to answer the question 'Why should I buy your product?'. The best way is to consider the answer in two stages:

1. **'Why should I buy your *product or service?*'**

   The answer comes naturally when you look carefully at customers' motives for buying and the benefits they get from the product.

2. **'Why should I buy *your* product or service?'**

   The only logical and satisfactory answer is: 'Because it's better and so it's different.'

   The difference can arise in two ways:

   - You, the seller, are different. To achieve this, you establish a particular niche for your business.

- Your product or service is different. Each product or service should have a unique selling point, based on fact.

Your promotional message must be built around the strength(s) of your product or service and must consist of facts about the company and about the product or service.

The stress here is on the word *fact*. Although many types of fact may surround you and your products, your customers are only interested in two – the facts that influence their buying decisions, and the facts of how your business and its products stand out from the competition.

The assumption is that everyone buys for obvious, logical reasons only, but of course innumerable examples show that this isn't so. Does a woman buy a new dress only when an old one is worn out? Do bosses have desks that are bigger than their subordinates' because they have more papers to put on them?

Choosing the media

Broadly, your advertising choices are *above-the-line* media, which is jargon for the Internet, newspapers and magazines, television, radio and other broadcast media, and *below-the-line* activities such as distributing brochures, leaflets, visiting cards, stationery, letterhead and the way you answer the phone.

The printed word (the Internet, newspapers and magazines) probably takes most of your above-the-line advertising budget. It's the accepted medium to reach the majority of customers. Most people read a newspaper, especially on Sunday, and magazines cater for every imaginable interest and range from parish magazines to Sunday supplements. News and articles are also increasingly available on the Internet, either as online versions of conventional papers or via blogs.

You must advertise where your buyers and consumers are likely to see your message. Your market research (which I talk about in Chapter 4) tells you where your likely prospects lie. Before making your decision about which paper or journal to advertise in, you need to get readership and circulation numbers and the publication's reader profile.

You can get this information directly from the journal or paper or from *BRAD* (British Rate and Data), www.brad.co.uk, which has a monthly classified directory of all UK and Republic of Ireland media. You should be able to access this through your local business library. The Audit Bureau of Circulations Electronic (www.abce.org.uk) audits website traffic, among other media, and Rajar (Radio Joint Audience Research) independently compiles radio audience statistics every quarter, providing an industry benchmark (www.rajar.co.uk). Newsgator (www.newsgator.com), and Blog Catalogue (www.blogcatalog.com) operate blog indexing services that can help you filter through the millions of blogs to let you home in on the ones that operate in your business sector.

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When considering below-the-line advertising, identify what business gurus call *moments of truth* – contact points between you, your product or service and your customer. Those moments offer you a chance to shine and make a great impression. You can spot the difference at once when you get a really helpful person on the phone or serving you in a shop. The same is true of product literature that's actually helpful, a fairly rare event in itself.

Some of the most effective promotional ideas are the simplest, for example a business card with a map on the reverse showing how to find you, or thank-you cards instead of letters on which you can show your company's recently completed designs.

Choosing the frequency

Think carefully about the timing of your advertising in relation to the kind of media you're considering. The copy dates of some monthly publications are two months before publication; trade exhibitions often only occur once or twice a year. This poses problems if you're waiting on a shipment or uncertain about a product change. Daily or weekly publications allow much prompter changes. The ultimate are probably the Internet, which can be updated minute by minute, and radio, where messages can be slotted in on the same day. Yearbooks, diaries and phone directories require long forward notice.

Writing a leaflet

Whether or not you actually use a leaflet as part of your advertising strategy, I always recommend writing one. The process forces you to think about what you have to tell potential customers about your product or service and, most importantly, what you want them to do next when they know of your existence. So if you want them to buy now, you need to give prices, availability, delivery times and so forth.

A leaflet doesn't have to be big – both sides of a sheet of A4 paper is as much as you can hope to get most readers to plough through, even if you're peddling the elixir of life. As well as carrying text, leaflets are a great way to get across more complex messages that a picture or diagram delivers best.

The rules for leaflets are that the content needs to be:

- Clear, straightforward English, simply laid out and easy to read
- Concise, using as few words as possible and jargon free
- Correct, because spelling mistakes and incorrect information destroy confidence in you and your product or service
- Complete, providing all the information needed for the reader to progress to the next stage in the buying process.

Christian Aid has a useful guide to basic leaflet writing (www.christianaid.org.uk; go to Act Now, then Useful Stuff and then How to Write a Press Release)aimed at charities and pressure groups, but also useful for a small business on a tight budget. And Hewlett-Packard offers professional-looking business materials with free, easy-to-use and customisable templates for creating leaflets, flyers, brochures and advertisements (www.hp.com/sbso/productivity/howto/marketing_main/marketing_brochure).

Using the Internet for viral marketing

The Internet is now central to the marketing process for most businesses. Even where customers don't buy online, most consumers and all business buyers check out products and services using the Internet to check price, quality and competitive offers. Increasingly, products that once had a physical presence are disappearing from the shelf. Music, software, film and now even books are available in 'soft' form to try or buy and download online.

Nine out of every ten visitors to a website arrive their via a search engine and your chances of being found depend on how your website is constructed, what words you use and where they're positioned on the page. This whole subject is so vital to a small firm's ability to compete that in this edition I have added in a whole new chapter on the subject; flick to Chapter 15.

Viral marketing is a term that describes the ability of the Internet to accelerate interest and awareness in a product by rapid word-of-mouth communications. To understand the mathematical power behind this phenomena, take a look at the nearby sidebar 'How viral marketing works'.

How viral marketing works

Take a look at recent communications networks and how they work.

The simplest are the 'one-to-one' broadcast systems such as television and radio. In such systems the overall value of the network rises in a simple relationship to the size of the audience. The bigger the audience, the more valuable your network. Mathematically, the value rises with N, where N represents the size of the audience. This relationship is known as Sarnoff's Law, after a pioneer of radio and television broadcasting.

Next in order of value comes the telephone network, a 'many-to-many' system where everyone can get in touch with anyone else. Here the mathematics are subtly different. With N people connected, every individual has the opportunity to connect with N–1 other people (you exclude yourself). So the total number of possible connections for N individuals = N (N–1). Or N^2–N. This relationship is known as Metcalf's Law, after Bob Metcalf, an inventor of computer networking. The size of a network under Metcalf's Law rises sharply as the value of N rises, much more so than with simple one-to-one networks.

The Internet, however, has added a further twist. As well as talking to each other, Internet users have the opportunity to form groups in a way they can't easily do on the telephone. Any Internet user can join discussion groups, auction groups, community sites and so on. The mathematics now becomes interesting. As David Reed, formerly of Lotus Development Corporation demonstrated, if you have N people in a network they can in theory form 2^n–N–1 different groups. You can check this formula by considering a small N, of say three people, A, B and C. They can form three different groups of two people, AB, AC and CB, and one group of three people, ABC, making a total of four groups as predicted by the formula. As the value on N increases the size of the network explodes.

The birth of viral marketing, using the power of Reed's Law to the full (see the sidebar 'How viral marketing works' for details of this law), has been attributed to the founder of Hotmail, who insisted that every email sent by a Hotmail user should incorporate the message: 'Get your free web-based email at Hotmail.' By clicking on this line of text, the recipient would be transported to the Hotmail home page. Although this email sent by the company itself wouldn't have had much effect, at the foot of an email sent by a business colleague or friend it made a powerful impact. The very act of sending a Hotmail message constituted an endorsement of the product and so the current customer was selling to future customers on the company's behalf just by communicating with them. The recipient of a Hotmail message discovered that the product works, but also that someone she respected or liked was a user.

You only have to see how quickly a harmful computer virus can spread in hours and days, to cover the whole world, to see the potential of viral marketing. For a small firm this technique has the added advantage of being inexpensive and easy to execute. Just look at some major sites on the Internet to get ideas. Book e-tailors all have links for you to email a friend about a book you've 'stumbled' across on their site. Travel sites encourage you to email any of their special offers that you don't plan to take up to a friend. However, the beauty and limitation of viral marketing is that it only works when you're talking about a good product. People don't recommend something they don't like using themselves.

Providing opportunities to see

The more opportunities you give potential customers to see your name or your product, the greater the chance of them remembering you. This is why direct mail letters usually involve more than one piece of literature. The theory is that the recipient looks at each piece before discarding it. The recipient may only give a brief scan, but it gives the seller another chance to hook a customer. So rather than using different advertising messages, try getting the same or a similar message to one customer group several times.

One claimed benefit of breakfast television is that it can get your message out before the shops open. In business-to-business sales, trade buyers are deluged with calendars, diaries, pen sets and message pads in the hope that when the buyer is making a decision, the promotional materials are still close at hand and have an influence on that decision.

Figuring your bang-for-the-buck ratio

You should only undertake advertising where you can realistically measure the results. Everything else is self-indulgent. The formula to keep in mind is:

> Effectiveness = Total cost of the advertising activity concerned ÷ Results (in measurable units such as

customers, new orders or enquiries)

A glance at the advertising analysis in Table 10-2 shows how one organisation went about measuring and comparing the effectiveness of different advertising methods. Table 10-2 shows the advertising results for a small business course run in London. At first glance the Sunday paper produced the most enquiries. Although it cost the most, £340, the cost per enquiry was only slightly more than the other media used. But the objective of this advertising wasn't simply to create interest; it was intended to sell places on the course. In fact, only 10 of the 75 enquiries were converted into orders – an advertising cost of £34 per head. On this basis the Sunday paper was between 2.5 and 3.5 times more expensive than any other medium.

Table 10-2 Measuring Advertising Effect

Media Used	*Enquiries*	*Cost of Advertising*	*Cost per Enquiry*	*No. of Customers*	*Advertising Cost per Customer*
		£	£		£
Sunday paper	75	340	4.50	10	34
Daily paper	55	234	4.25	17	14
Posters	30	125	4.20	10	12
Local weekly paper	10	40	4.00	4	10
Personal recom-mendation	20	N/A	N/A	19	N/A

Getting in the News

Getting your business into the news is one of the most cost-effective ways to get your message in front of both actual and potential customers. People see papers, TV and journals, on and offline, as being unbiased and so they have a greater impact on their audiences than pure adverts. It goes without saying that what you're looking for is favourable news. If you do have bad news coming through, check out this website: www.aboutpublicrelations.net/crisis.htm.

The surest way to get in the news is to write a press release. Better still, write lots of them. To be successful, a press release needs to get attention immediately and be quick and easy to digest. Studying and copying the style of the particular journals (or other media) you want your press release to appear in can make publication more likely.

The introduction is the most vital part. Ask yourself, 'Will what I write make the reader want to read on?' Avoid detail and sidetracks. The paragraphs should have bite and flow. Keep the sentences reasonably short. State the main point of the story or information early on. Follow these suggestions for a successful press release:

- Type the release on a sheet of A4 paper headed 'Press Release' or 'Press Information'. Address it to the News Editor, News Desk or a named journalist.
- Use double spacing and wide margins to allow for editorial changes and printing instructions, respectively. Use one side of the paper only.
- Date the release and put a headline on to identify it. This must persuade the editor to read on. If it doesn't attract interest, it'll be quickly 'spiked'. Editors are looking for topicality, originality, personality and, sometimes, humour.

- Tell your story in three paragraphs. The substance should come in the first one. The first paragraph must say who, what, why, when and where, and succeeding paragraphs can fill in the detail. If space is short then a sub-editor deletes from the bottom and papers are always looking for fillers – short items that they can drop into gaps. Even if the bulk of the story is cut, at least the main facts may get printed.
- Include at least one direct quotation or comment, always from a named individual and ideally from someone of standing or relevance.
- Keep the press release simple and write for the readership. The general public prefers images or descriptions to technical facts. For example, you can describe a new car lock as being able to keep out a professional thief for 30 minutes for a story in the general press. For the trade press the same story may be better supported by facts about the number of levers, codes and so forth that are involved in beefing up the lock's security system.
- Finish with a contact for more information. Give phone numbers for work and home and a mobile number, as well as your email and website addresses. This helps a journalist looking for more detail – if a gap occurs suddenly and you're available for further information, your story may be more attractive.
- Submit the release before the paper or journal's deadline. All the media work to strict deadlines. Many local papers sold on a Friday are printed on a Tuesday or Wednesday morning. A release that fails to make it by then probably gets ignored. The national dailies, of course, have more flexibility and often have several editions. At the other end of the scale, many colour

supplements and monthly journals have a cut-off date six weeks in advance.

- Steer away from selling your firm and product, and write news. Anything else is advertising and may be discarded. You're not writing an advertisement, you're telling a story to interest readers.
- A good picture is worth a thousand words, as the adage goes. Certainly, from a journalist's point of view it's worth half a page of text she doesn't have to write herself.

Deciding who to contact

Remember that the target audience for your press release is the professional editor, who is the person who decides what to print. With British editors receiving an average of 80–90 press releases per week, make sure that you're publicising your latest newsworthy item, but make sure your press release is free of puffery and jargon.

Do your research to find not only the right newspapers or journals, but also the right journalists. Read their columns, or listen to or watch their programmes, and become familiar with their style and approach to news stories. Hollis (www.hollis-pr.com) publishes the details of all news contacts, listed by business area for newspapers, radio and television. Your goal is to write a press release that's so close to a journalist's own style that she has almost no additional work to do to make your news usable.

Following through

You get better results if you follow up your press release with a quick phone call. Journalists get bogged down and distracted like everyone else, so don't be too surprised if your masterpiece sinks to the bottom of a pile of prospective stories before the day is out. That phone call, or even an email if you can't get through, is often enough to keep up interest and get your story through the first sifting.

When you start getting results you want to keep the effort going. But even if you aren't successful at first, don't be disappointed or disheartened. Keep plugging away. Try to find a story regularly for the local press and get to know your local journalists and editors. Always be truthful, helpful and available. If a media contact rings you and you're in a meeting, make sure you always ring back.

Some companies always seem to get a piece in the paper every week. The stories published aren't always earth-shattering news, but the continuous drip of press coverage eventually makes an impact. For example, Virgin Airways was boosted immeasurably by successful press coverage. Few of the millions of words of copy written about Branson or Virgin have been paid for.

Using blogs and social networks

Consumers increasingly get influenced by their peer's views as to what to buy and do. This process of disseminating information was once the exclusive domain of mainstream advertising and of comment in the press or on the news. The Internet has changed the game and now everyone can find out from consumers how good or bad a product or service is.

Blogs, Facebook, Foursquare, Twitter and a host of other social networks are now an important and in some cases – such as when marketing to the under 25s – the only way to get your message across. Often more systematic processes are in place; TripAdvisor for information on hotel users' experiences is a good example, where different aspects of a hotel experience – accommodation, service, value for money – are rated on a points scale. This allows potential customers to see if the particular aspect or aspects they are looking for in a hotel are likely to be delivered.

So you need to build these social network routes into your marketing plans. Shiv Singh's *Social Media Marketing For Dummies* (published by Wiley) contains everything you need to know about this vital topic.

Selling and Salesmanship

More direct than advertising or publicity, selling is at the heart of every business. Whatever kind of selling your business involves, from moving goods over a counter to negotiating complex contracts, you need to understand the whole selling process and be involved with every aspect of it.

Telling the difference between selling and marketing

Marketing involves the whole process of deciding what to sell, who to sell it to and how. The theory is that a brilliant marketing strategy should all but eliminate the need for selling. After all, selling is mostly concerned with shoe-horning customers into products that they don't really want, isn't it? Absolutely not! Although the more effort you put into targeting the right product or service to the right market, the less arduous the selling process is, you still have a selling job to do.

The primary job of the sales operation is to act as a bridge or conduit between the product and the customer. Across that gulf flows information as well as products and services. You need to tell customers about your great new ideas and how your product or service performs better than anything they've seen to date.

Most businesses need selling and marketing activities in equal measure to get their message across effectively and get goods and services into their markets.

Selling yourself

One of the most important operational issues to address is your personal selling style. If you've sold products or services before, you may have developed a successful selling style already. If not, you need to develop one that's appropriate for your customers and comfortable for you. Regardless of your experience, assessing your selling style helps define and reinforce your business goals.

Check that you and your salespeople always see things from the customer's point of view. Review the sales styles of your salespeople to see how they can improve. Consider whether your own and your salespeople's selling styles are *consultative*, where you win the customer over to your point of view, or *hard*, where you try forcing the customer to take your product or service.

In assessing your selling style, consider the following:

- Always have a specific objective for any selling activity, together with a fall-back position. For example, your aim may be to get an order, but you may settle for the chance to tender for a customer's business. If you don't have objectives, much of your sales activity may be wasted on courtesy calls that never reach the asking-for-an-order stage.

- The right person to sell to is the one who makes the buying decision. You may have to start further down the chain, but you should always know whom you finally have to convince.
- Set up the situation so you can listen to the customer. You can best do this by asking open questions that look for long answers as opposed to closed questions that solicit a 'yes or no' response. When the customer has revealed what her needs really are, confirm these back to her.
- Explain your product or service in terms of the customer's needs and requirements.
- Deal with objections without hostility or irritation. Objections are a sign that the customer is interested enough in what you have to say at least to discuss your proposition. After you've overcome the customer's objections and established a broad body of agreement, you can try to close the deal.
- JARGON ALERT Your approach to closing can be one of a number of ways. The *assumptive close* takes the tack that because you and the customer are so much in agreement, an order is the next logical step. If the position is less clear you can go for the *balance sheet close*, which involves going through the pros and cons, arriving at a larger number of pros. So once again, the most logical way forward is for the customer to order. If circumstances allow, you can use the *special situation* closing technique. This may be appropriate if a product

is in scarce supply or on special offer for a limited period.

- If you're unsuccessful, start the selling process again using your fall-back objective as the goal.

Outsourcing selling

Hiring sales people can prove to be too costly for a new or small business. A lower-cost and perhaps less risky sales route is via agents. Good agents should have existing contacts in your field, know buyers personally and have detailed knowledge of your product's market. Unlike someone you recruit, a hired agent should be off to a flying start from day one.

The big difference is that agents are paid purely on commission – if they don't sell they don't earn. The commission amount varies, but is rarely less than 7 per cent of the selling price and 25 per cent isn't unknown.

You can find an agent by advertising in your specialist trade press or newspapers such as the *Daily Telegraph* and *Exchange and Mart.* You can also try the Manufacturers' Agents' Association (MAA; website: www.themaa.co.uk; tel: 01582 767618), whose membership consists entirely of commission agents selling in all fields of business. The website has a search facility that can help you find a sales agent by geographical area, industry sector or types of customer served. You have to pay £150 plus £26.25 VAT by credit card for an MAA Net Search, allowing you to contact up to 20 agents in one search. Alternatively, trade directories list other agents' associations. However, the most reliable method is to approach outlets where you wish to sell. They know the honest, competent and regular agents who call on them. Draw up a shortlist and invite those agents to apply to you.

The International Union of Commercial Agents and Brokers (www.iucab.org/nl) has details on some 470,000 commercial agents in Europe and North and South America.

When interviewing potential sales agents, you should find out:

- What other companies and products do they already sell? You want them to sell related but not competing products or services to yours.
- What's their knowledge of the trade and geographical area that you cover? Sound them out for specific knowledge of your target market.
- Who are their contacts?
- What's their proven selling record? Find out who their biggest customers are and talk to these directly.
- Do they appear honest, reliable and fit to represent your business? Take up references and talk to their customers.

Finding professional representation is a challenge, so your product has to be first-class and your growth prospects good, with plenty of promotional material and back-up support.

When you do find someone to represent your product, draw up an agreement to cover the main points, including geographical area, commission rates, when commission is payable, customers you want to continue dealing with yourself, training and support given, prohibiting competing agencies and periods of notice required to terminate. Also build in an initial trial period after which both parties can agree to part amicably.

Measuring results

Sales results can take time to appear. In the meantime you need to make sure you or your agent are doing things that eventually lead to successful sales. You should measure the following:

Activities

- Sales appointments made
- Sales calls made per day, per week, per month. Monitor trends, because last quarter's sales calls give you a good feel for this quarter's sales results
- Quotations given

Results

- New accounts opened
- Old accounts lost
- Average order size

Pricing for Profit

Pricing is another element of the marketing mix and represents the biggest decision you have to make about your business and the one that has the biggest impact on company profitability. You need to keep pricing constantly under review.

To get a better appreciation of the factors that may have an influence on what you charge, every business should keep these factors in mind.

Caring about business conditions

Obviously, the overall conditions in the marketplace have a bearing on your pricing policy. In boom conditions, where products are so popular that they're virtually being rationed, you can expect the overall level of prices for some products to rise disproportionately. And conditions can vary so much from place to place that they have a major impact on pricing. For example, one business starter produced her beauty treatment price list based on prices near to her home in Surrey. However, she planned to move to Cornwall to start her business, where prices were 50 per cent lower, reflecting lower rates of pay in the county. So although she got a boost by selling her Surrey home for much more than she paid for a house in Cornwall, that gain was offset by having to charge much lower prices for her services.

Seasonal factors can also contribute to changes in the general level of prices. A turkey, for example, costs less on the afternoon of Christmas Eve than it does at the start of Christmas week.

Working to your capacity

Your capacity to produce your product or service, bearing in mind market conditions, influences the price you set. Typically, a new venture has limited capacity at the start. A valid entry strategy may be to price high enough to just fill your capacity, rather than so low as to swamp you.

A housewife started a home ironing service at £5.50 per hour's ironing, in line with competition, but because she only had 20 hours a week to work in, she rapidly ran out of time. It took six months to get her price up to £7 an hour and her demand down to 20 hours per week. Then she was able to recruit some assistance and had a high enough margin to pay some outworkers and make some profit herself.

Understanding consumer perceptions

A major consideration when setting your prices is customers' perception of the value of your product or service. Their opinion of value may have little or no relation to its cost, and they may be ignorant of the price that the competition charges, especially if your product or service is a new one.

Skimming versus penetrating

The overall image that you want to portray in the marketplace influences the prices you charge. A high-quality image calls for higher pricing, naturally. However, within that pricing policy you have the option of either setting a high price, which just *skims* the market by only being attractive to a small population of wealthier customers; or going for a low price to *penetrate* the market, appealing to the mass of customers.

Skim pricing is often adopted with new products with little or no competition that are aimed at affluent buyers who are willing to pay more to be the trendsetters for a new product. After the innovators have been creamed off the market, you can drop the price to penetrate to lower layers of demand.

The danger with this strategy is that high prices attract the interest of new competitors. If you have a product that's easy to copy and impossible to patent, you may be better off setting the price low to discourage competitors and to spread your product throughout the market quickly.

Avoiding setting prices too low

The most frequent mistake that companies make when setting a selling price for the first time is to pitch it too low. Either through failing to understand all the costs associated with making and marketing your product, or through yielding to the temptation to undercut the competition at the outset, you set your price so low that you risk killing your company.

Pondering Place and Distribution

Place is the fourth ‘p’ in the marketing mix. Place makes you review exactly how you get your products or service to your customers.

If you’re a retailer, restaurateur or garage proprietor, for example, then your customers come to you. Your physical location probably is the key to success. If your business is in the manufacturing field, you’re more likely to go out and find customers. In this case, your channels of distribution are the vital link.

Even if you’re already in business and plan to stay in the same location, you may find benefit in taking the opportunity to review that decision. If you’re looking for additional funds to expand your business, your location is undoubtedly an area that prospective financiers want to explore.

Choosing a location

From your market research data you should be able to come up with a list of criteria that are important to your choice of location. Some of the factors you need to weigh up when deciding where to locate are:

- If you need skilled or specialist labour, is it readily available?
- Are the necessary back-up services available, such as computer support, equipment repairs and maintenance?
- How readily available are raw materials, components and other supplies?
- How does the cost of premises, rates and utilities compare with other areas?
- How accessible is the site by road, rail and air?
- Are there any changes in the pipeline that may adversely affect trade? Examples include a new motorway bypassing the town, changes in transport services and closure of a large factory.
- Are there competing businesses in the immediate neighbourhood? Are these likely to have a beneficial or detrimental effect?
- Is the location conducive to the creation of a favourable market image? For instance, a high-fashion designer may lack credibility trading from an area famous for its heavy industry and infamous for its dirt and pollution.
- Is the area generally regarded as low or high growth? Is the area favourable to businesses?
- Can you and your key employees get to the area easily and quickly?

You may even have spotted a role model – a successful competitor, perhaps in another town, who appears to have got the location spot on. You can use its location criteria as a guide to developing your own.

Using these criteria you can quickly screen out most unsuitable areas. You may have to visit other locations several times, at different hours of the day and on different days of the week, before screening these out too.

Working from home

If you plan to work from home, have you checked that you aren't prohibited from doing so by the house deeds, or whether your type of activity is likely to irritate the neighbours? This route into business is much in favour with sources of debt finance, because it lowers the risks during the vulnerable start-up period. Venture capitalists, on the other hand, may well see it as a sign of 'thinking too small' and steer clear of the proposition. Nevertheless, working from home can make sound sense.

You also have to consider whether working from home suits you and your partner's domestic arrangements. For instance, if you have young children you may find difficulty in explaining to them that you're really at work, when everything looks much the same all the time.

If you're the type of person who needs the physical separation of work and home to give a structure to your life, then working from home may not be right for you. I cover this subject in detail in Chapter 3.

Selecting a distribution channel

When you know where you want to locate, selecting a distribution channel involves researching methods and deciding on the best way to get your product to your customers.

Moving a product through a distribution channel calls for two sorts of selling activity. *Push* is the name given to selling your product in, for example, a shop. *Pull* is the effort that you carry out on the shop's behalf to help it sell your product. Your advertising strategy or a merchandising activity may cause the pull. You need to know how much push and pull are needed for the channel you're considering. If you aren't geared up to help retailers sell your product, and they need that help, then this may be a poor channel for you.

The way in which you have to move your product to your end customers is an important factor to weigh up when choosing a channel. As well as such factors as the cost of carriage, you also have to decide about packaging materials. As a rough rule, the more stages in the distribution channel, the more robust and expensive your packaging has to be.

Not all channels of distribution settle their bills promptly. For example, mail-order customers pay in advance, but retailers can take up to 90 days or more to pay. You need to take account of this settlement period in your cash-flow forecast.

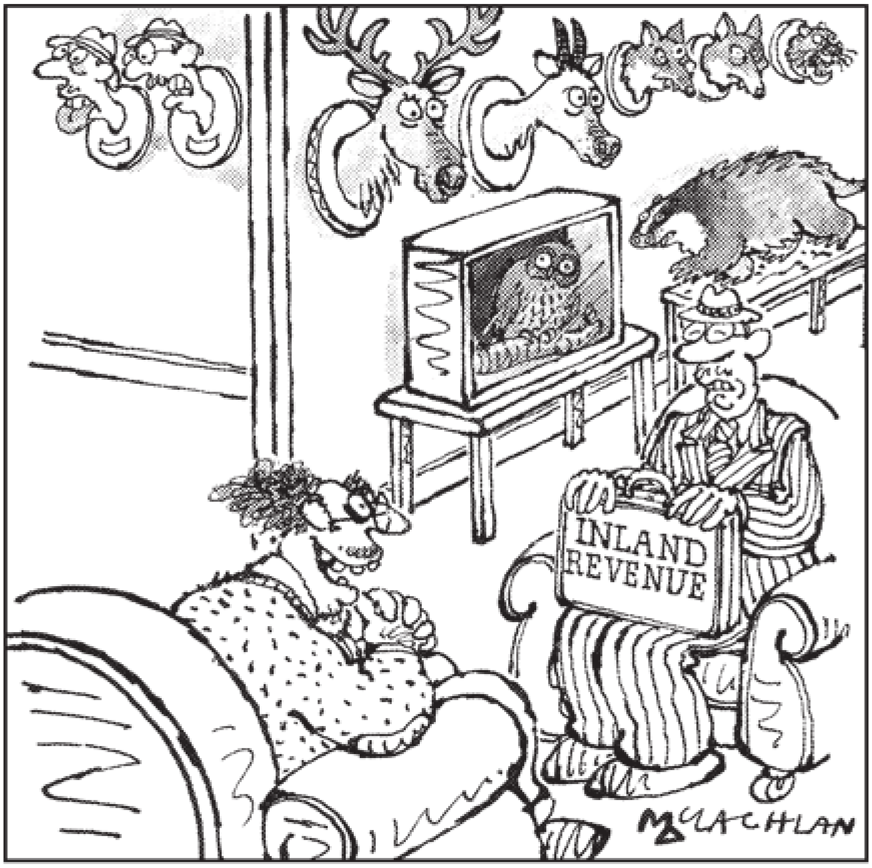
Consider these factors when choosing channels of distribution for your particular business:

- *Does the channel meet your customers' needs?* You have to find out how your customers expect their product or service to be delivered to them and whether they need that particular route.
- *Will the product itself survive?* Fresh vegetables, for example, need to be moved quickly from where they're

grown to where they're consumed.

- *Can you sell enough this way?* 'Enough' is how much you want to sell.
- *Is the channel compatible with your image?* If you're selling a luxury product, then door-to-door selling may spoil the impression you're trying to create in the rest of your marketing effort.
- *How do your competitors distribute?* If they've been around for a while and are obviously successful, you may benefit from looking at how your competitors distribute and using that knowledge to your advantage.
- *Is the channel cost-effective?* A small manufacturer may not find it cost-effective to supply retailers in a particular area because the direct 'drop' size – that is, the load per order – is too small to be worthwhile.
- *Is the mark-up enough?* If your product can't bear at least a 100 per cent mark-up, then it's unlikely that you can sell it through department stores. Your distribution channel has to be able to make a profit from selling your product too.

Part III
Staying in Business



'Good heavens – this tax investigation must be really serious – You're the third tax inspector to visit my little taxidermist business this month.'

In this part . . .

Once your business is up and running the problems don't stop or slow down: They just change. Selling successfully may have looked like your biggest problem before you started out, but once you get going, recruiting and managing employees takes on at least as much importance.

Even if you make piles of profit, you have to keep alert to ways to make sure that the HM Revenue and Customs gets no more than its fair share of the proceeds. You may find that you have to manage not only your own money, but VAT (Value Added Tax), PAYE (Pay as You Earn), and NI (National Insurance).

Chapter 11

Employing People

In This Chapter

- Finding the best employees for your business
- Deciding on motivations and rewards
- Keeping on the right side of employment law

Unless you intend working on your own, when running a business you're involved in employing and motivating others to do what you want them to do. Even if you don't employ people full-time, or if you outsource some portion of your work to others, you have to choose who to give those tasks to, how to get the best out of people and how to reward their achievements.

Finding Great Employees

First, you may need to change your attitude to the whole hiring process. Most entrepreneurs dislike hiring employees, so they do it as little as possible and fit it around their other 'more important' tasks.

Finding good staff is *the* number one job for a boss. You need good people to delegate to. And bringing new people into your current team can bring fresh and innovative ideas to stimulate everyone on to greater heights.

If you hope to grow your business, recruitment will become a routine task, like selling or monitoring cash flow that you do every day. Furthermore, you need a budget to carry out recruitment and selection, just as you need a budget for equipment or rent. If you don't have a recruitment budget, you shouldn't be surprised if a task for which you've budgeted no money goes wrong.

Deciding on full- or part-timers

One important decision you need to make before you can start your search for staff is whether you need to hire a full-time person. Some very good reasons may exist for not doing so. If, for example, the demand for your products is highly seasonal and has major peaks and troughs, keeping people on during slack periods may make no sense. This may be the case if you're selling heating oil, where you can expect demand to peak in the autumn and tail off in the late spring because of variations in the weather. Other examples of seasonal fluctuations are increased sales of garden furniture and barbeques in summer, and toys and luxury items before Christmas.

Using part-timers can open up whole new markets of job applicants, sometimes of a higher quality than you may expect on the general job market. Highly skilled and experienced retired workers, or women who've given up successful careers to have a family, can be tempted back into temporary or part-time work. You may sometimes be able to have two members of staff sharing one job, each working part-time. You can also use this tactic to retain key staff members who want to leave full-time employment. This makes for continuity in the work, allows people to fit in their job around their personal circumstances and brings to the business talents that it may lose if it insists on full-time work.

Part-time work is more prevalent than many people think. Up to a third of all those in employment in some countries are working part-time and most of those are working in small firms whose flexibility in this area can often be a key strength over larger firms when it comes to recruiting and retaining employees.

You can find part-time staff using the same methods as for full-time employees, which I discuss in the next sections.

Recruiting and selecting

To make sure that you get great people into your business, follow the tips in these sections.

Reviewing your business goals

The starting point for any recruitment activity is a review of your short- and medium-term business goals. If you've recently updated your business plan, then your goals will be fresh in your mind. If not, then you need to do so. You need to be sure exactly who you're going to recruit. For example, if you plan to sell and service software via your website, then the people you need may be quite different from those required if you plan to supply physical products.

Defining the job(s)

Set out the scope and responsibilities of the job before you start recruiting. The job description should include the measurable outcomes that you expect, as well as a description of the tasks the person is to do. So for a salesperson, spell out what the sales target is, how many calls you expect the person to make, what the customer retention target is and so on.

Too many small firms don't get round to preparing a job description until the person is in place, or worse still they don't have job descriptions at all. They argue that because jobs in the small business world have a short shelf-life because the company is growing and changing all the time, why bother? If you don't know what you want the person you recruit to be doing, then he won't know either.

Profiling the person

Flesh out your idea of the sort of person who can do the job well. If you're looking for a salesperson, then communication skills and appearance are important factors to consider, as are the person's personal circumstances, because he may have to stay away from home frequently. Make sure that you pay regard to discrimination legislation when looking at candidates' personal circumstances (I cover this in the section 'Avoiding discrimination', later in this chapter).

As well as qualifications and experience, keep in mind the person's team skills and that all too rare attribute, business savvy.

Advertising the job

You can fill positions from outside your company but also from inside it – don't overlook your existing staff. You may be able to promote from within, even if you have to provide some additional training. Also, your staff, suppliers or other business contacts may know of someone in their network who may be suitable.

You can advertise in newspapers and also on the Internet, which has a proliferation of recruitment websites and is a major source of staff.

The type of vacancy you have determines the medium that's best for you. The Internet may be right for design engineers, but a leaflet drop on a housing estate can be better when looking for shift workers.

Advertising for recruitment is subject to legal restrictions that vary from country to country. The laws most likely to apply are those relating to discrimination on the grounds of gender, race, age, religion or sexual orientation. Avoid sexist language or *he* or *she*, and select your words carefully to avoid stipulating characteristics that exclude potential applicants of a specific sex or race or in a particular age range. If in doubt, consult the Advertising Standards Authority (www.asa.org.uk) or take legal advice. Most restrictions apply to newspapers, magazines, radio and television; however, you're wise to include the Internet on that list.

Making your selection

When you have a number of applicants, first screen out the people who don't meet your specifications. Phone them if you need to clarify something, for example to establish whether they have experience of a particular software package. Then interview your shortlist, perhaps using a test where relevant to your business. Many self-administered tests are available, designed for different types of work – I talk about tests in 'Testing to find the best', later in this chapter.

If the search process has been successful you'll probably end up with more good applicants than you have time to interview. You need to evaluate all the applicants against cut-off criteria such as qualifications, experience, potential to grow with the job and travel time to work.

Set your criteria into a short-listing matrix – a table with criteria in the rows and candidates in the columns – and score candidates between one and three against each criterion, with three being a very good rating and one being barely acceptable. (The Newcastle University website at www.ncl.ac.uk/hr/forms/recruit has a neat short-listing matrix that you can adapt to any job profile, as well as dozens of other useful recruitment templates.) You could set the cut-off point where applicants below a certain standard wouldn't be offered a job under any circumstances. Raise the standard if this still leaves you with an overly large list of candidates to interview.

You need to thoroughly prepare before interviewing job applicants.. When interviewing, you need to:

- **Have a pre-prepared list of the key questions you plan to ask.**
- **Allow the candidate to talk freely as long as he sticks to the point.** If the candidate strays from dealing with areas on your list, bring him back by asking your questions.
- **Give applicants time to reply to your questions.** Don't fill every silence with another question, but if the silence persists for about ten seconds ask the candidate if he'd like you to clarify the question.

- **Look for specific evidence of the skills you're seeking.** Without those no possibility exists that the candidate will be suitable.
- **Ask questions that will give you an impression of the candidate's motivation,** such as 'What made you decide to . . .?'
- **Avoid asking leading questions, and be sensitive to potential discriminatory questions** (for example, age, sex, religion and ethnic group).
- **Avoid dominating the interview.** The candidate should be speaking for at least 75 per cent of the interview.
- **Close the interview on a positive note.** Leave the candidate feeling that he's had a fair hearing and has no further questions to ask. Indicate approximately when the candidate is likely to hear from you and what the next stage in the selection process is.

Six good interview questions

A good interview question gives you the specific information that you seek, and helps you to form a view about how the candidate's mind works, the type of person he is and whether or not he'd fit into your business. Here are a few suggestions. You don't have to use them all, but review them to see which you could use in an interview and add some questions of your own, based on the job and your reading of the candidate's CV. You could also check out Rob Yeung's *Answering Tough Interview Questions For Dummies* (Wiley) for many more great interviewing questions.

- **What are your greatest strengths and weaknesses?** You need to look behind the reply to see what the candidate really means. Claiming to have no weaknesses, or admitting only to a weakness that's just a thinly disguised strength, should put you on your guard. Tie any claimed strengths back to specific achievements mentioned on the application form.

- **How could your current employer be more successful?** This question is designed to see whether the applicant has thought about the bigger picture of what his employer's core competence is or should be. You want people to do their jobs well, but you need every employee in a small firm to know what your mission and goals are, so they can play a full part in the business.

- **What was your greatest achievement and greatest failure?** The wording of this question may change depending on whether you're talking to a delivery driver or an export sales manager, but the thinking is the same. You need to find out whether the candidate has done anything to make a difference by using his own initiative. Look for measurable factors. Watch out for candidates who present their failures as someone else's fault because they may not be up to accepting personal responsibility.

- **What do you know about our business and why do you want to work here?** If a candidate can't answer this question well then you know he isn't interested and that this is just any old job to him.

- **What do you see yourself doing in three years' (or three months', if appropriate) time?** Here you're trying to find out about a candidate's ambitions and then see whether they're realistic and likely to be achievable in your business. If the candidate can't achieve those goals then his stay with you might be a short one. Remember, you need low flyers too.

- **If you were to be hired, in which areas could you contribute immediately?** This gives you an idea of how ready the applicant is now and what kind of short-term payback you might get from having him work for you. You'll also see how much he's absorbed about your business and the job on offer.

You may want to let the applicants meet other people in the business. This gives them a better feel for the company and you can get a second opinion on them. When Apple was developing the Macintosh, the entire Mac team was involved in every new appointment. Applicants spent a day with the team, and only when the team decided that a person was suitable did they let him in on the project.

Ideally, you end up with at least three people whom you'd be happy to appoint. Offer the job to the best candidate, keeping the others in reserve. You must have a reserve in case your first choice lets you down, accepts but then changes his mind or quits or is fired after a week or two.

Always take up references, preferably on the phone. Don't accept 'testimonials' at face value.

Welcoming new employees

Having got the right people to join you, make sure they become productive quickly and stay for a long time. The best way to do this is to have a comprehensive induction process showing them where everything is and the way things are done in your business. Keep them posted about developments – put them on the email circulation list straight away. Set them short-term objectives and monitor performance weekly, perhaps even daily at first, giving praise or help as required. Invite them to social events as appropriate.

Testing to find the best

You can supplement the classic trio of selection methods – application letter or CV, interviews and references – with other tools that can improve your chances of getting the right candidate for most of the jobs you may want to fill. These tools are often clustered under the general heading of *psychometric tests*, although most of the tests themselves have less to do with psychology than with basic aptitude.

Although tests are popular and becoming more reliable, they're neither certain to get selection decisions right nor risk free.

Dozens of commercial test publishers exist, producing over 3,000 different tests. You can locate a test and some guidance on which is best for your business needs through the British Psychological Society (www.bps.org.uk/hopc/collarch/tests$.cfm) or the Chartered Institute of Personnel and Development (www.cipd.co.uk; click on Subjects, then Recruitment and Talent Management and then Selection Methods).

Exploring Other Ways of Recruiting

You don't have to do everything involved in recruiting employees yourself. You can find a recruitment consultant or use a government Job Centre to do much of the hard work for you. In fact, they may even be better at this than you, because they recruit and select every day of the week. Research suggests that recruitment consultants, for example, are twice as successful at filling vacancies than are entrepreneurs on their own.

You could consider taking the job in question out of your business and pay someone else to do it. See 'Outsourcing jobs', later in this chapter, for more on this.

Using agencies

Occasions may well occur when you feel that you're either unable or unwilling to do the job of recruiting yourself. In such circumstances you may find it useful to use a recruitment agency. The costs involved may sound high, but when you reckon up your internal costs you may find that an agency isn't that expensive. Doing the recruiting yourself can take several days of your time and that of others in your firm. If you're working on your own or with just one or two others, this may be too great a distraction from other key tasks.

The Recruitment and Employment Confederation (www.rec.uk.com) has a searchable database of recruitment consultants listed by postcode, region and business sector. Also check out the online magazine *Recruitment Consultant* (www.rec-con.co.uk) for information and resources on many aspects of recruitment.

Using Job Centre Plus

Job Centre Plus is the government-run employment service that has professionally run offices with a growing number of staff specialising in small and medium enterprises (SMEs). Typically, the service operates out of 1,000 Job Centres based in towns where job seekers are likely to live. At any one time it has 400,000 job seekers on its database.

Job Centre Plus is particularly helpful to small firms with little experience of recruiting, because it offers a wide range of free help and advice on most matters concerned with employing people as well as signposting to other related services.

The Job Centre Plus range of services includes everything you expect of a recruitment consultant. But unlike other recruitment agencies, many of its services are free and in any event cost less than using any other external recruiter. You can find details of all its services for employers at Job Centre Plus (www.dwp.gov.uk/about-dwp/customer-delivery/jobcentre-plus).

Recruiting over the Internet

The fastest-growing route to finding new job applicants is via the Internet. The number of websites offering employment opportunities has exploded in recent years. The advantages of Internet recruitment to both candidates and clients are obvious. Internet recruitment offers a fast, immediate and cheap service compared to more traditional methods of recruitment. A number of recruitment sites have established formidable reputations in Europe and the US. These include:

- **Futurestep** (www.futurestep.com), which covers all job functions and industry sectors.
- **Monster** (www.monster.co.uk), which attracts approximately 100,000 visits per month and contains over a million curricula vitae. Its vacancies cover every industry sector and regional area.
- **Web Recruit** (www.webrecruit.co.uk), which offers to fill your vacancy through its online service for £695, or give you your money back.

Another option is to have a job-listing section on your own website. This is absolutely free, although you're certain to be trawling in a very small pool. This may not matter if the right sort of people are already visiting your site. At least they know something about your products and services before they apply.

Outsourcing jobs

If you want to, you can probably buy in almost every part of the work you do from external sources. Other companies can design and host your website and you can rent other technology. External warehouses can hold stock of your product; transport companies can deliver on your behalf; third-party call centres can handle your customer services; and online banks compete with traditional banks to offer online payment processing. You can outsource almost every other aspect of business – from accounting and recruitment, to payroll and human resource services.

Motivating and Rewarding Employees

After you've recruited the staff you want, you need to manage them in the most suitable way for your business. Management is the art and science of getting people to do what you want them to do because *they* want to do it. This is easier said than done.

Most entrepreneurs believe that their employees work for money and their key staff work for more money. Pay them enough and they'll jump through any hoop. In contrast, most research ranks pay as third or even fourth in the reasons for people coming to work.

If they don't necessarily work for money, why do people work in a particular organisation? I help provide some of the answers in the following sections.

Getting the best out of employees

My best advice for getting the best out of your employees is: get to know everyone. This may sound insane in a small firm – after all, you almost certainly recruited them all in the first place. By observing and listening to your employees you can motivate them by making them feel special.

The starting point in getting people to give of their best is to assess them as individuals and to recognise their specific needs and motivations. A person's age, gender or job influences these differences, as does the individual's personality. You need to tailor your actions to each person to get the best results.

Some practical tools and techniques can help you get the most out of your employees.

- **Show an interest in people's work.** This has nothing to do with monitoring performance and more to do with managing by walking about, seeing everyone and talking with them as often as possible.

  If you employ fewer than five people you need to spend some time with each of them every day; up to ten people spend time with them every week. After that, you should have managers doing much the same thing, but you still need to get around as often as possible.

- **Give praise as often as you can.** The rule is simple: minimise your reaction to bad results and maximise your appreciation of good results. Autocratic employers continually criticise and complain, finding only poor performance wherever they look. Criticism reinforces poor behaviour. Everyone wants to be recognised and strangely enough people often prefer to be shouted at than ignored. So if doing things wrong is the only way to get noticed in your company, that's what may well happen.

If you do need to criticise, keep it constructive and lighten it with some favourable comment. For example, if an employee is making some progress but is short of being satisfactory, saying something like 'This is certainly an improvement, but we still have a way to go. Let's spend a little time together and I'll see whether we can't get to the bottom of what's holding you back' may produce a better level of motivation than just shouting out your criticism.

- **Create a no-blame culture.** Everything in business is a risk.

  To a greater or lesser extent, you delegate some of the responsibility for taking risks to your employees. But how should you react when the inevitable happens and things go wrong? If you jump up and down with rage, then no one will ever take a risk again. They'll leave all the decisions to you and you'll become even more overworked. Good people will get highly demotivated and leave. If you take a sympathetic and constructive attitude to failure, you motivate and encourage employees to try again.

  You need to make clear that tolerance of mistakes has its limits and that repetition of the same mistake won't receive an equally tolerant reaction.

- **Reduce demotivation.** Very often the problem isn't so much motivating people, but avoiding demotivating them! If you can keep off employees' backs they're more likely to motivate themselves. After all, most people want the same things – a sense of achievement or challenge, recognition of their efforts, an interesting and varied job, opportunities for responsibility, advancement and job growth.

Dealing with difficult or demotivated employees

Difficult or demotivated people need prompt and effective managing. Dissatisfaction can spread quickly and lower other people's motivation levels. The first step is to identify the causes of the problem – is it to do with the employee or with the job itself? The problem may be brought about by illness, stress or a personality clash between people working together.

Whatever the cause, the initiative for remotivating an employee has to come from you. However, the only reason for going through this effort is that either the employee has delivered satisfactory results in the past or you believe he has the potential to do so, if you can only find the key.

Keeping motivation in the family

Over 80 per cent of small businesses are family businesses in which one or more relatives work in the organisation. Family businesses have both strengths and weaknesses when it comes to motivation. By being aware of them you can exploit the former and do your best to overcome the latter to give your business a better chance of prospering.

The factors that motivate or demotivate family members can be different to those affecting non-family members.

The overwhelming strength of a family business is its different atmosphere and feel. A sense of belonging and common purpose usually leads to good motivation and performance.

Another advantage is that a family firm has greater flexibility, because the unity of management and shareholders provides the opportunity to make quick decisions and to implement rapid change if necessary. On the downside, several weaknesses exist. Although these weaknesses aren't unique to family businesses, family firms are particularly prone to them.

- **Unwillingness to change is the single most common cause of low motivation in family firms.** Family firms often do things the way they've always done them just because that's the way they've always done them. This can lead to stagnation in the marketplace and failing confidence in investors. Resistance to change is exacerbated by diminishing vitality, as the founders grow old.
- **Family goals and commercial goals can come into conflict.** Unlike other businesses, family firms have additional objectives to their financial performance targets, such as building family reputation and status in the community; providing employment for the family; protecting family wealth; ensuring independence; and a dynastic wish to pass on a position, in addition to wealth, to the next generation. However, superimposing these family values on the business can lead to difficulties. For example, nepotism may lead to employment of family members at a level beyond their competence, or a salary above their worth. This can lead to discontent and be demotivational for non-family members.
- **Conflict may exist between growth and ownership.** Families prefer majority ownership of a small company to minority holdings in a big company where they're answerable to outside shareholders. A dilemma that all family managers face is either growing the company,

keeping purely commercial goals in mind at whatever risk to family control, or subordinating the firm's welfare to family constraints. This affects all areas of the business, from recruitment through to management.

- **The impact and career prospects of non-family employees may be limited.** At management level family pride sometimes doesn't allow a situation where its members are subordinate to an outsider – even if the outsider is a better person for the job. Also, reliance on family management to the exclusion of input from outsiders may starve a growing firm of new ideas. A family firm may become inward looking, insensitive to the messages of the marketplace, unreceptive to outside ideas and unwilling to recruit competent outside managers. None of these factors is likely to be motivational to others in the business.

A family firm must address these problems to avoid all the effort it puts into motivating employees being seen as a cynical deception. Having a clear statement of family policy on the employment of family members, succession and ownership can be helpful. Then non-family members can either buy into this policy or not join the company in the first place.

Rewarding achievements

Different types of work have different measurable outcomes. You need to identify the outcomes you want and arrive at a scale showing the base rate of pay and payment above that base for achieving particular objectives. Different types of 'payment by results' schemes are in common use and to make sure you pick the right mix of goals and rewards, examine carefully the conditions that most favour these types of pay.

Setting pay scales

People don’t come to work just for money, but they certainly won’t come if you don’t pay them, and they won’t stay and be motivated to give of their best if you don’t give them the right pay. But how much is the right amount? Get it too low and you impair your ability to attract and retain productive and reliable people capable of growing as your business grows. But pay too much and your overheads rise so high that you become uncompetitive. Small firms face the very real danger of a wage bill that represents their largest single business expense.

The ground rules for pay aren’t very complicated but they are important:

- Pay only what you can afford. Don’t sink the company with a wage bill that it can’t meet.
- Make sure that pay is fair and equitable and that everyone sees it as such.
- Make sure that people know how you arrive at your pay scales.
- See that pay scales for different jobs reflect the relative importance of the job and the skills required.
- Ensure that your pay scales are in line with the law on minimum wage requirements. The UK has a *statutory minimum wage*, the amount of which is governed by the age of the employee and whether an employee is undergoing training. The hourly rate changes over time, so you need to keep abreast of the latest rates (www.hmrc.gov.uk/nmw has information on current rules in this area).

- Ensure that your pay scales are competitive with those of other employers in your region or industry. PayScale (www.payscale.com/hr/default) is a site where you can get accurate real-time information on pay scales.

Ways to find out the going rate for a job include:

- Read articles on pay, as well as job advertisements on the Internet, in local papers and in the relevant trade journals. You may have to correct some pay rates to allow for variations. For example, pay rates for similar jobs are often much higher in or near major cities than they are in rural areas.
- Talk to your chamber of commerce or trade association, some of which publish salary surveys, and to other local employers and business owners in your network.
- Contact employment agencies, including those run by the government. They're usually a bit ahead of the rest of the market in terms of pay information. Other employers know only what they're paying their present staff. Recruitment agencies know what you have to pay to get your next employee.

Deciding the pay rates of people who work for you arbitrarily may appear to be one of the perks of working for yourself. But inconsistent pay rates quickly upset people and staff members tend to jump ship at the first opportunity.

Matching pay to performance

You may want to add to people's salaries by rewarding them with money or benefits for the level of performance they achieve. I discuss various reward approaches in this section, which all follow the same ground rules for matching pay to performance:

- Make the rules clear so that everyone knows how the reward system works.
- Make the goals to be achieved specific and if possible quantifiable.
- Make the reward visible so that everyone knows what each person or team receives.
- Make the reward matter. It has to be worthwhile and commensurate with the effort involved.
- Make the reward fair, so that people believe it's correctly calculated.
- Make the goals realistic, because if you set the target too high no one will try to achieve it.
- Make the reward happen quickly.

Paying a commission

This is perhaps the easiest reward system, but it really only works for those directly involved in selling. A *commission* is a payment based in some way on the value of sales that the individual or team concerned has secured.

You have to make sure that the order is actually delivered or executed before you pay any commission and you may even want to make sure that the customer has paid up. However, as with all rewards, you must keep the timescale between doing the work and getting the reward as short as practicably possible, otherwise people forget what the money is for.

Base the commission on your gross profit (the value of sales less the cost of generating those sales) rather than your sales turnover – otherwise you can end up rewarding salespeople for generating unprofitable business.

Awarding bonuses

A *bonus* is a reward for successful performance, usually paid in a lump sum related as closely as possible to the results that an individual, team or the business as a whole has obtained. In general, bonuses are tied to results, so that how an individual contributed directly to the result achieved is less obvious. For example, a company bonus may be paid to everyone if the firm as a whole achieves a certain level of output. Keeping everyone informed about how the firm is performing towards achieving that goal may well be motivational, but the exact role that, say, a cleaner or office worker has in helping to attain that goal isn't easy to assess – not as easy as it is to calculate a salesperson's commission.

You can pay bonuses periodically or as a one-off payment for a specific achievement.

Sharing profits

Profit sharing involves giving a specific share of the company's profit to its employees. The share of the profits can be different for different jobs, length of service or seniority.

This type of reward has the great merit of focusing everyone's attention on the firm's primary economic goal – to make money.

One or more employees can be performing well while others drag down the overall performance. In theory, in such circumstances the high-performing staff put pressure on the others to come up to the mark.

If profits go up, people get more; but profits can also go down, which can be less attractive. Also, the business can miss profit targets for reasons outside of employees' direct control. If your company depends on customers or supplies from overseas, for example, and the exchange rate moves against you, profits, and hence profit-related pay, can dip sharply. However unfair this may seem to a receptionist who's been hoping for extra cash to pay for a holiday, this is the hard reality of business. If you think your employees are adult enough to take that fact on board, then profit sharing can be a useful way to reward staff.

Sharing ownership

Share option schemes give employees the chance to share in the increase in value of a company's shares as it grows and prospers.

The attraction of turning employees into shareholders is that doing so gives them a long-term stake in the business, hopefully makes them look beyond short-term issues and ensures their long-term loyalty. Of course, unwelcome side effects can occur if the value of the business goes down rather than up. Share schemes also have some important tax implications that you need to take into account. You can find out all about these on the HM Revenue and Customs website (www.hmrc.gov.uk/shareschemes).

Giving skill and competence awards

You can give a skill or competence award when an employee reaches a certain level of ability. These awards aren't directly tied to an output such as improved performance, but you must believe that raising the skill or competence in question ultimately leads to better business results.

The award itself can be cash, gift certificates, extra days of holiday, a trip to a show or sports event or whatever else your employees may appreciate. Bottles of wine always seem to be well received!

Creating a menu of benefits

A *benefit* is defined as any form of compensation that’s not part of an employee’s basic pay and isn’t tied directly to his performance in his job. Non-salary benefits such as a pension or changes in working conditions can also play a part in keeping people on your side.

A wide range of other perks is on offer to employees, ranging from being allowed to wear casual dress to on-site childcare. Other benefits available in some organisations include personal development training, company product discounts, flexible hours, telecommuting and fitness facilities.

It’s now obligatory to consider flexible working if an employee requests it and has sufficient reason and setting up some form of pension scheme looks set to become compulsory for most businesses soon.

Staying on the Right Side of Employment Law

All businesses operate within a legal framework, the elements of which the owner-manager must be aware. The areas I cover in the following sections summarise only a few of the key legal issues. Different types of business may have to consider different legal issues and employment law itself is dynamic and subject to revision and change.

The Advisory, Conciliation and Arbitration Service (ACAS; www.acas.org.uk) and the British Safety Council (www.britishsafetycouncil.org) are useful organisations that can help with aspects of employment issues. Emplaw (www.emplaw.co.uk) is a website covering basic British employment law information and can direct you to a lawyer in your area who specialises in the aspect of employment law you're concerned with.

Keeping employment records

You need to keep records about your employees, both individually and collectively. Keeping proper records makes the process of employing people run more smoothly. Some of the data you need to keep is a legal requirement, such as information on accidents. Some of the information is also invaluable in any dispute with an employee, for example in a case of unfair dismissal.

The individual employee information you retain should include:

- Application form
- Interview record and results of any selection tests used
- Job history, including details of promotions and assignments

- Current and past job descriptions
- Current pay and bonus details and a record of the amount and date of any changes
- Details of skills and competences
- Education and training records, with details of courses attended
- Details of performance assessments and appraisals
- Absence, lateness, accident, medical and disciplinary records, together with details of any formal warnings and suspensions
- Holiday entitlement
- Pension contribution data
- Termination record giving date, details of exit interview and suitability for re-engagement
- Copies of any correspondence between you and the employee

Collective information should include:

- Numbers of staff, grades and job titles
- Absenteeism, staff turnover and lateness statistics
- Accident rates
- Records on age and length of service
- Wage and salary structures
- Employee costs
- Overtime statistics showing hours worked and costs
- Records of grievances and disputes

- Training records showing how many person days have been devoted to training and how much that's cost
- Gender, ethnic and disability profiles

Employees have three basic rights over the information an employer keeps in their employment records:

- To be able to obtain access to their personal data
- To be able to claim damages for losses caused by the use of inaccurate data or the unauthorised use of data, or by the loss or destruction of data
- To apply to the courts if necessary for rectification or erasure of inaccurate data

This means that an employee is entitled to gain access to his personal data at reasonable intervals and without undue delay or expense. This request must legally be put in writing, although you may choose not to insist on this, and you must provide the information within 40 days of the request.

Preparing contracts of employment

You have to give an employee a written statement of certain terms and conditions of his employment within two months of his starting working for you.

The list of terms that form part of this statement include the following:

- The employee's full name
- When the employee started working for you

- How and how much you pay your employee
- Whether pay is weekly or monthly
- The hours you expect the employee to work
- The number of days' holiday the employee is allowed, including public holidays, and how that holiday is accumulated
- The employee's job title or a brief description of his work
- Where you expect the employee to work and what conditions apply if you expect him to work elsewhere
- You need to state whether you intend the employment to be permanent or, if it's for a fixed term, when it starts and finishes
- Details of who manages the employee and whom he can talk to if he has any dispute with that person
- Any terms and conditions relating to sickness or injury, including any provision for sick pay
- Any terms and conditions relating to pensions and pension schemes
- Any disciplinary rules applicable to the employee
- The period of notice required, which increases with length of service; a legal minimum of one week's notice per year of service is required up to a maximum of 12 weeks (express terms in the contract may override this)

The job description forms the cornerstone of the contract of employment that exists between employer and employee. However, the contract is rarely a single document and may not even be completely documented. A contract comes into existence as soon as someone accepts an offer of paid employment, even if both offer and acceptance are only verbal. In practice, the most important contractual document may be the letter offering the person the job, and detailing the salary and other basic employment conditions. Many employers don't document the contractual relationship with employees properly and end up with disputes. A contract of employment consists of four sets of terms:

- **Express terms:** Terms specifically agreed to between employer and employee, whether in writing or not.
- **Implied terms:** Terms considered to be so obvious that they don't need spelling out. These include such matters as the employee complying with reasonable instructions and taking care of business property and equipment. For the employer these can include taking reasonable care of the employee and paying him for work done.
- **Incorporated terms:** Terms from outside sources, most commonly from trade union agreements, which are included in the contract.
- **Statutory terms:** These include any work requirements laid down by law – safety regulations, for example.

The Business Link website has information on everything you need to meet your obligations as an employer when it comes to taking on staff (www.businesslink.gov.uk; go to Employment and Skills, then Becoming an Employer and then Taking on a New Employee).

Working legal hours

Although the owner of a business may be content to work all hours, the law strictly governs the amount of time employees can be asked to put in. The Working Time Regulations apply to any staff over the minimum school-leaving age. This includes temporary workers, home workers and people working for you overseas.

As an employer, you must keep records that show you comply with the working-time limits and that you've given night workers the opportunity for a health assessment.

The Directgov website has information on everything you need regarding working hours (www.direct.gov.uk; click on Employment, then Employment Terms and Conditions and then Working Hours).

Granting leave

Occasions are bound to arise when you're obliged to give your staff time off work other than their usual holidays or when they're unwell. You have to meet statutory obligations of course. Otherwise you may not have to pay them when these occasions occur, but you do have to respect their right to be absent for compassionate or sickness reasons. And if they are off sick, always meet up with them when they return, just to make sure that all is well and that there are not any underlying problems.

Protecting parents

Employees who become parents either naturally or by adopting a child are entitled to paid time off and other benefits, including Statutory Maternity, Paternity and Adoption Pay. The employee may also be entitled to have his job back at some later date.

Work Smart, a Trade Union Council-run website, has a full description of the latest rules and regulations on these ever-changing topics. (Go to www.worksmart.org.uk, click on Your Rights and then Working Life and Family-friendly Policies.)

Recognising emergency leave

Employees have the right to reasonable unpaid leave where their *dependants* – spouses, children, parents, other people living in an employee's house (except lodgers) and others who rely on an employee in emergencies, such as elderly neighbours – are affected by:

- Illness, injury, assault or childbirth
- Breakdown in childcare/other care arrangements
- The consequences of a death
- A serious incident at school or during school hours

To take this leave, your employee should give notice as soon as reasonably practical, giving the reason for, and likely duration of, his absence. The legislation doesn't define *reasonable* time off, but usually one or two days should suffice.

Avoiding discrimination

By and large business owners can employ whoever they want. However, when setting the criteria for a particular job or promotion discriminating on the grounds of sex, race, age, marital status, religious beliefs, sexual orientation or union membership is usually illegal. Regulations also prevent part-time employees from being treated less favourably than comparable full-time employees – that is, someone doing broadly similar work and with a similar level of skills and qualifications. The Emplaw website (www.emplaw.co.uk) has a free area covering the current regulations in British employment law, and also details on how you can find a lawyer in your area who specialises in the aspect of employment law you're concerned with.

Discrimination starts right from when vacancies are advertised – you can't include such phrases as 'women required' or 'young person sought', or 'no blacks' or 'no whites'. It extends to the pay, training and promotion of those who work for you.

Victimising someone who's complained about being discriminated against is illegal. Sexual harassment is also a form of discrimination, defined as the 'unwanted conduct of a sexual nature or other conduct based on sex affecting the dignity of men and women at work'. This can include unwelcome physical, verbal or non-verbal conduct. Finally, it's unfair to include in your reason for dismissing an employee that he's a member of a particular minority group protected by law.

WARNING! To avoid discriminating in your employment, you need to ensure that all your policies and procedures meet the following criteria:

- They're applied equally to all who work for you irrespective of sex, race and so forth.
- They don't limit the proportion of one group who comply compared with another.
- They don't disadvantage any individual.
- They can be objectively justified. For example, no argument exists when being a man or a woman is a genuine occupational qualification – for example, for the purpose of a particular photographic modelling

assignment or an acting role. The same is true when you have a part-time vacancy so have no need of a full-time employee.

To make sure that you're not discriminating at work, follow this six-point checklist:

- Ensure that your business has an equal opportunities policy. You can find a sample policy on the Equality and Human Rights website (www.equalityhumanrights.com).
- Train staff in equal opportunities policies.
- Keep records of interviews showing why you rejected candidates.
- Ensure that you take complaints about discrimination seriously, fully investigate them and address any problems that emerge.
- Conduct staff surveys to help determine where discrimination may exist within your business.
- Examine the payroll – pay should reflect employees' job titles, not their gender.

Keeping the work environment healthy and safe

By law you have to provide a reasonably safe and healthy environment for your employees, visitors and members of the general public who may be affected by what you do. This applies to both the premises you work from and the work itself. An inspector has the right to enter your premises to examine it and enforce legal requirements if your standards fall short in any way.

When you have employees you must take some or all of the following measures, depending on the number of people you employ. However, a prudent employer should take all these measures whether or not the law requires them. Doing so sets a standard of behaviour that's common in the very best firms.

- Inform the organisation responsible for health and safety at work for your business of where you are and what you do. For most small businesses this is the Environmental Health Department of your local authority (you can find contact details in your local telephone directory). The Health and Safety Executive website (www.hse.gov.uk) has a section devoted to small firms, covering both regulations and advice on making your work environment safer.
- Get employer's liability insurance to cover you for any physical injury or disease your employees may suffer as a result of their work. The amount of coverage must be at least £2 million and the insurance certificate must be displayed at all your places of work.

You, as an employer, can in turn expect your employees:

- To take reasonable care of their own health, safety at work and of other people who may be affected by their acts or omissions
- To co-operate with the employer in ensuring that the requirements imposed by the relevant statutory provisions are complied with

Chapter 12

Operating Effectively

In This Chapter

- Selecting premises
- Opting to make it yourself or buy from outside
- Choosing and using suppliers
- Looking at operating risks
- Delving into directors
- Deciding on key business advisers

Although you've decided to go into business, it doesn't necessarily mean that you have to make your own product, carry out every aspect of the business yourself or even work from a dedicated premises. The best use of your time may be to outsource the most time-consuming and least valuable aspect of your business. For example, I bet you can't get a package from Milton Keynes to Penzance in under 24 hours and see change from a £20 note! But a delivery service can.

Whether you buy in most of what you sell, or just some components and assemble them yourself, you have to choose between the dozens if not hundreds of suppliers in the market. Price alone is rarely a good enough guide to which supplier to choose. If they can't deliver on time, price is irrelevant.

You have to face risks in your business, not all of which you either want to or are able to shoulder yourself. For these you have to make choices about insurance types and levels to cover you. Even if you're a director of your limited company, some of those company risks fall on you and the consequences of getting things wrong can be serious, even catastrophic.

Fortunately, you don't have to face all these decisions alone. Plenty of advisers are there to help. This chapter looks at the decisions and risks involved in running a business and helps you to choose someone to help you through the minefield.

Proposing Premises

If you can avoid taking on premises when starting up your business, perhaps by working from home, so much the better. (See 'Working from home' in Chapter 3 for more information.) If that's not an option, read on.

Buying or leasing, the term used for renting a business premises, entails navigating through a number of important and often complex regulations, as well as the practical nuts and bolts of finding, fitting out and settling in to the premises. These regulations go way beyond the scope of the physical premises into areas such as opening hours and health and safety.

Calculating requirements

The first decision to make is how much space you actually require and what other facilities you need. The space is the easy bit. You can take the steam age route and make cut-out scale models of the various items you need – chairs, desks, tables and so forth – and set them out on scaled drawings of the premises. By a process of trial and error you should be able to arrive at an arrangement that's flexible, convenient to work in and meets the needs of customers and staff alike. You can also take the high-tech route and use a software program to save on the scissor work. Try Google's free program Sketchup (http://sketchup.google.com), a 3D modelling software tool that's easy to learn and simple to use. Alternatively, for around $90 you can buy a package from Smart Draw (www.smartdraw.com/specials/officeplanning.asp); you can try for free before you buy.

Finding the right premises

As soon as you know where you want to be, how much space you need and any special requirements, you can hit the trail visiting local estate agents, reading the local press and generally keeping your ear to the ground. You can, of course, get someone else to do much of the donkey work for you and put your valuable time to more productive work such as finding customers or raising dosh. Office Planet (www.office-planet.net) and Official Space (www.officialspace.co.uk), for example, provide free office-finding services. You can search through their databases of available properties and create a shortlist of solutions that meet your needs, or simply call an adviser.

If you're looking for a workshop, warehouse or showroom that doesn't have to be in the centre of a town, Ashtenne (www.ashtenne-online.co.uk; an Industrial Fund Unit Trust that owns 500 industrial estates around the UK ranging in size from 500 to 50,000 square feet) and Comproperty (www.comproperty.com) operate online databases for buying, selling or leasing commercial property and businesses in the UK.

For retail premises, Shop Property (www.shopproperty.co.uk) and Daltons Business (www.daltonsbusiness.com) have online databases of shops for sale and rent, searchable by price, size and location throughout the UK.

Renting or owning?

This is another of those imponderable questions. Buying a premises gives you all sorts of advantages, not least that you can make any alterations you want (if the law allows) without going cap in hand to a landlord, and of course no one can kick you out. On the downside, you have to invest a substantial amount of money up front and you have to sell up if you outgrow the premises. You of course enjoy any rise in the value of the property, but if you really believe that property is a better bet than investing in your own business, perhaps you should rethink your business proposition.

Renting isn't without its problems, however. You have to take on the property for a number of years and even if you sublet with the landlord's permission, you're liable for rent for the full period should the person you sublet to default. Rents are reviewed, almost invariably upwards, every three to seven years. You're expected to keep the property in good repair and return it to the landlord at the end of the lease period in the condition it was at the outset. That can prove expensive if the landlord doesn't share your opinion that any changes you've made constitute an improvement.

Net Lawman (www.netlawman.co.uk/info/business-property-lease.php) provides free advice and information to both landlords and tenants about business leases. Also, the Communities and Local Government website has a guide to the law governing commercial property leases (www.communities.gov.uk/publications/regeneration/businesstenancies).

Sorting out equipment

After you've found the right premises you need to furnish them. A number of items such as furniture, shelving, filing and computing equipment are common to many types of business. Some require more specialised items, including cookers, commercial printers and machine tools. Only in the most exceptional cases should a start-up business buy new equipment. Aside from the basic economics – new may cost two to three times as much as used – until you get trading you have no real idea of what you actually need.

These are useful sites, apart from the ubiquitous eBay, on which to search out second-hand business equipment:

- Auction Guide (www.auctionguide.com)
- Greasy Machines (www.greasymachines.com)
- MM Börse Online (www.mm-boerse.de)
- Office Furniture Desks and Chairs (www.officefurnituredesksandchairs.co.uk)

Searching for suppliers of new products is best done using a business-to-business directory, such as those provided by Business Magnet (www.businessmagnet.co.uk), Kelly Search (www.kellysearch.co.uk) and Kompass (www.kompass.co.uk), which between them have global databases of over 2 million industrial and commercial companies in 200 countries, listing over 200,000 product categories. You can search by category, country and brand name.

Taking the Make-or-Buy Decision

If your business involves making or constructing products, then you should address the issue of whether to make the product yourself or to buy it either ready to sell or as components for assembly.

Making it yourself – pros and cons

If you decide to make the whole of your product yourself, or at least a major part of it, you need to decide exactly what plant and equipment you need and how many pieces you can produce at what rate. Then you have to consider such factors as what engineering support, if any, you need and how to monitor and control quality.

The great advantage of manufacturing your product yourself is that you have control over every aspect of the business and its products. You can, in theory at least, step up production to meet extra demand, make minor modifications to a product to meet a customer's particular needs and have the resources in-house to develop prototypes of new products to respond to changing market conditions.

However, some possible disadvantages of making products yourself in a start-up business are:

- The large outlay of money needed from day one.
- The deflection of management time, mostly your own, to looking inwards at processes rather than outwards at the marketplace.
- Established manufacturers being better and cheaper than you are at various elements of the production process – after all, they've been at it longer than you and have the benefit of being further up the learning curve

and further down the cost curve than any start-up can realistically expect to be.

Outsourcing – a low investment option

Outsourcing, contracting out the production of your product or the supply of your service, has become a buzzword. Thousands of articles and hundreds of books have been written on the subject and you can attend countless related seminars. An Internet search on *outsourcing* brings up more links than you can ever hope to handle.

One way to set the boundaries for outsourcing is to decide what you're good at, and then outsource everything else. In other words, focus your company on your core competency, and 'stick to the knitting'. That logic is sound in theory, and to a certain degree in practice, but like everything else you can take it too far. The key is to understand your business and its goals and decide how outsourcing can help you attain them.

Some things are central to your business and you shouldn't outsource them, at least at the outset. You need to keep an eye (your eye!) on them until you have them fully under control. These include cash-flow management and most aspects of customer relations. Later on you may consider, for example, outsourcing collecting cash from customers to an invoice discounter or factoring service (which I talk about in Chapter 8), which may have better processes in place to handle larger volumes of invoices than you can afford.

Some tasks make sense to outsource initially and bring in-house later. If you plan to offer a product or service that you're not expert at, you may benefit from contracting out this core function, at least until you gain confidence and expertise. For example, if you plan to start an upmarket soup kitchen but aren't very experienced at making soup, you can turn to an established soup chef to cook for you. The outside expert charges you a premium, but for that you get significant value – the contractor understands your requirements, produces the product and delivers it to your site with little risk to you. If the quality is wrong, you send it back. If you need more product, you order it. You don't have to wait for your new equipment to arrive before you can step up production.

Setting quality standards

Quality may well be, like beauty, in the eye of the beholder, but you're wise to set clear standards that you expect every aspect of your end product or service to conform to. This is true whether you make in-house or outsource.

A number of well-regarded quality standards may help you monitor and control your quality. The BS EN ISO 9000 series provides perhaps the best-known standards. They can ensure that your operating procedure delivers a consistent and acceptable standard of products or services. If you're supplying to large firms they may insist on your meeting one of these quality standards, or on auditing your premises to satisfy themselves. The British Standards Institute (www.bsi-global.com) can provide details of quality standards.

A number of commercial organisations provide user-friendly guidelines and systems to help you reach the necessary standard. Searching the web using keywords such as *Quality standards* or *Measurement* brings up some useful sites.

Choosing a Supplier

Selecting the wrong supplier for your business can be a stressful and expensive experience. This section offers some pointers on how to find a supplier and make sure that your supplier can meet your business needs. (Chapter 4 talks about similar issues, so you may want to consult that chapter too.)

Look for value in the service a supplier offers rather than just the price you pay. The key questions you should ask about any prospective suppliers to your business are:

- Do they offer a guaranteed level of service?
- Do they have a strong business track record and evidence of financial stability? Check out their accounts at Companies House (www.companieshouse.gov.uk).
- Do they have clients in your business sector and local area?
- Can they provide you with client references and impartial evidence of their quality? You should check out references to make sure that suppliers are reliable and can meet deadlines.
- Can they meet rushed deliveries in case of emergency?
- What level of after-sales support do they provide?
- Do they offer value for money when compared to competitive services?
- Do you think you can enjoy working with them? If so, the relationship is going to be more productive.

Thomas's Register (www.thomasnet.com), Kelly's (www.kelly.co.uk) and Kompass (www.kompass.com) between them have details on over 1.6 million British companies and hundreds of thousands of American and Canadian manufacturers, covering 23 million key products and 744,000 trade and brand names. If someone makes a particular product, you can find their details in one of these directories.

Some free search facilities are available online. Your local business library also holds hard copies of directories and may even have Internet access to all the key data you may ever need on suppliers.

Evaluating trading terms

Buying is the mirror image of selling. Remember that as you negotiate with suppliers, who are essentially selling their services. Even if they have no deliberate intention to mislead, you may be left thinking that a supplier isn't committed to doing what you want in the way you want it. So get any agreement in writing.

The starting point in establishing trading terms is to make sure that suppliers can actually do what you want and what they claim to be able to do. This involves checking them out and taking up references.

The next crunch point is price. As a small business you may feel you're fairly short on buying power. That may be true, but room for negotiation always exists. All suppliers want more customers and sometimes they want them badly enough to shift on price.

If you do your research by contacting several suppliers so that you have a good idea of the price parameters before you talk seriously to any supplier, set yourself a target discount price and start negotiating 10 per cent or so below that. In any negotiation you may well have to give ground, so if you start at your target price you end up paying more.

The supplier's opening claim is likely to be that they never negotiate on price. Don't be deterred. Many ways exist to get your costs down without changing the headline price. Some examples are:

- Allowing a certain percentage of free product, along the line of a free bottle of wine with every half case, can nudge the price down by 15 per cent.
- Agreeing to hold stock in the supplier's warehouse saves you from the need to rent your own warehouse.
- Benefiting from an extra 30 days' credit eases your cash flow and may be the difference between growing your young business and standing still.

You need to examine all the contract terms, such as delivery, payment terms, risk and ownership (the point at which title to the goods passes from the maker to you), warranties and guarantees, termination, arbitration rules if you fall out and the governing law in dealings with overseas suppliers. These issues are the same ones you deal with when you set your own terms of trade, so turn to Chapter 5 for a detailed review.

Building a relationship

To ensure that you handle any problems you have with your suppliers effectively, you need to build relationships with them. That means talking to them and keeping them informed of your plans and intentions. If you're planning a sales drive, new price list or other similar activity, let suppliers know so that they can anticipate the possible impact on them. Keeping them informed doesn’t commit you to buying extra product, or indeed any product beyond that contracted for, but it does make your suppliers feel part of the value chain between you and your customers. By involving suppliers you’re indirectly encouraging them to commit to helping you meet your goals.

Many businesspeople pay too much for the goods or services they purchase, which shows up as lower gross margins and poorer performance than the competition. Many of these people don’t raise the issue with their supplier but instead start looking elsewhere for an alternative source. Don’t make their mistake. More often than not, your supplier prefers to discuss the terms of your arrangement than lose your business. In many cases, you both end up with a better deal than before.

Buying online

Buying online has a range of important benefits for a small firm. Big companies have buying departments whose job is to find the best suppliers in the world with the most competitive prices and trading terms. A small firm can achieve much the same at a fraction of the cost by buying online – it can lower costs, save scarce management time and get supplies just in time, hence speeding up cash flow and reducing stock space, along with a range of other benefits.

The range of goods and services that you can buy online is vast and getting larger. As well as office supplies you can buy computer equipment, software, motor vehicles, machine tools, vending equipment, insurance, hotel accommodation, airline tickets, business education, building materials, tractors, work clothing and cleaning equipment, to name but a few.

You can use several methods to buy business supplies online. I explain the most useful methods in the following sections.

Joining an e-buying group

Online buying groups go by various names, including trading hubs, e-marketplaces, online communities, aggregators and cost reducers.

Buying in this way allows you to collect information from potential vendors quickly and easily. These online markets gather multiple suppliers in one place so that you can comparison shop without leaving your office or picking up the phone. For example, if you need to buy toner cartridges for your office laser printer, you can go to an online marketplace and search the catalogues of multiple office supplies vendors, buying from the one that offers the best deal. You can also do this for bigger-ticket items such as office furniture or photocopiers. No more calling a handful of potential suppliers, sitting through sales presentations and negotiating prices. Comparison shopping saves you time for more valuable business activities and gets you a better rate.

TIP Buying Groups (www.buyinggroups.co.uk) offers an online guide to British buying groups and purchasing consortia. Also, e-Three (www.e-three.com) offers a service to facilitate collaboration with other organisations to leverage purchasing volumes and so secure more competitive prices and terms.

Going in for auctions

Online auctions are another way to buy supplies online. Their advantage is that you pay only as much as you're willing to. The disadvantage is that you may have to wait for the right deal to come up.

Auctions are a great way to significantly reduce the funds you need to purchase items on your business *wish list* – items you want now or need eventually but that aren't a current necessity. (See 'Sorting out equipment', earlier in this chapter.)

Bartering online

You can avoid using hard cash by taking advantage of online barter exchanges. These e-exchanges let you trade your company's products and services for those of other businesses. You can swap ad space for accounting services, or consulting for computers. For start-ups or cash-strapped companies, barter can be an effective way to get products or services you may otherwise be unable to afford. An organisation that can help you get started with bartering is Bartercard (website www.bartercard.co.uk; tel. 0845 219 7000).

Minimising Risk and Assessing Liability

As the saying goes, no pain, no gain. Some of the pain is routine and you can allow for it in the normal course of events. Employees come and go, you have to pay suppliers, you have to move into and out of premises. But some events are less easy to predict and can have serious if not disastrous consequences for your business. What happens if the warehouse burns down or your pizzas send a few customers to hospital?

You can't be expected to know that such things will happen ahead of time, but you can be reasonably sure that *something* will happen *sometime.* The laws of probability point to it and the law of averages gives you a basis for estimating your chances. You have to be prepared to deal with the unexpected, which is what this section helps you do.

Insurance forms a guarantee against loss. You must weigh up to what extent your business assets are exposed to risk and what effect a particular event may have on the business if it occurs.

> One very simple way to assess risk is to get an insurance quote to cover the risk. Insuring against an earthquake in London is very cheap, but the same cover in Istanbul costs a significant sum.

Insurance is an overhead, producing no benefit until a calamity occurs. How much insurance to carry is therefore a commercial decision, and although the temptation exists to minimise cover, you should resist it. You must carry some insurance cover, either by employment law or as an obligation that a mortgager imposes.

Establish your insurance needs by discussing your business plans with an insurance broker. Make sure that you know exactly what insurance you're buying; and, because insurance is a competitive business, get at least three quotations before making up your mind.

The Association of British Insurers (ABI; www.abi.org.uk) and the British Insurance Brokers' Association (BIBA; www.biba.org.uk) can put you in touch with a qualified insurance expert.

Protecting your employees

You must carry at least £2 million of liability insurance to meet your legal liabilities for death or bodily injury incurred by an employee during the course of business. In practice, this cover is usually unlimited, with the premiums directly related to your wage bill.

Employer's liability covers only those accidents in which the employer is held to be legally responsible. You may want to extend this cover to any accident to an employee while on your business, whoever is at fault. You may also have to cover your own financial security, particularly if the business depends on your being fit and well.

Covering yourself against an employee suing

The advent of no-win, no-fee legal support is encouraging more individuals to feel confident enough to take on companies both big and small, and often in circumstances where their chances of success aren't immediately obvious.

The growing burden of employment legislation facing small firms is forcing more and more businesses to take out legal expense insurance as the risk for being prosecuted for breaking the law rises.

But not only the risk is rising. The consequences of breaking the law are spiralling upwards too. The ceiling for unfair dismissal awards has risen from £50,000 with the maximum sum recently awarded of £84,005, just one example of the burden of new employment laws. In 2009 some 52,711 unfair dismissal claims were filed, up from 40,941 the previous year.

The Job Rights website has an unfair dismissal calculator. (www.jobrights.co.uk/unfair-dismissal-calculator.htm). Just put in age, years of service, pay and a number of other factors including how long it might take for the person to get another job and – hey presto! – a number appears. The figure may not match the actual bill when it comes in, because the law is an uncertain arena. But it gives you something to work with from a budgeting perspective.

The remedy for the small firm without its own human resources department to keep it operating clearly within legal boundaries and a legal department to fend off any legal threats is to take out legal expenses insurance.

Firms that sign up for this type of insurance can not only expect the insurance company to pay any fines and awards they incur, but also their costs associated with defending themselves against allegations.

Protecting assets

Obviously, you need to insure your business premises, plant and equipment. However, you can choose between a couple of ways to do that:

- **Reinstatement** provides for full replacement cost.
- **Indemnity** meets only the current market value of your asset.

You also have to consider related costs and coverage. For example, who pays for removing debris? Who pays the architect to design the structure if you have to rebuild? Who reimburses employees for any damaged or destroyed personal effects? And potentially the most expensive of all: who covers the cost of making sure that a replacement building meets current, possibly more stringent and more expensive, standards?

The small print of your insurance policy covers these factors, so if they matter to your business check them out.

From raw materials through to finished goods, stock is as exposed as your buildings and plant in the event of hazards such as fire and theft. Theft from commercial property runs to hundreds of millions of pounds per annum.

When you're in business you can expect threats from within and without. You can take out a *fidelity guarantee*, the name of this particular type of insurance, to protect you from fraud or dishonesty on the part of key employees. You can also take out normal theft cover to protect your business premises and their contents.

Covering loss of profits

Meeting the replacement costs of buildings, plant, equipment and stock doesn't compensate you for the loss of business and profit arising out of a fire or other disaster. Your overheads, employees' wages and so on may have to continue during the period of interruption. You may incur expenses such as getting subcontracted work done. Insurance for *consequential loss*, as this type of insurance is known, is intended to restore your business's finances to the position they were in before the interruption occurred.

Goods in transit

Until your goods reach your customers and they accept them, the goods are still at your risk. You may need to protect yourself from loss or damage in transit.

Protecting yourself

Anyone who puts a substantial amount of money into your business – a bank or a venture capitalist, for example – may require you to have *key man insurance.* This type of insurance provides a substantial cash cushion in the event of your death or incapacity – you being the key man (even if you're a woman) on whom the business's success depends.

Key man insurance is particularly important in small and new firms where one person is disproportionately vital in the early stages. In a partnership, your partners may also consider this a prudent protection.

Guaranteeing goods and services

As well as your own specifications confirming how your products or services perform, you may have legal obligations under the *Consumer Protection Act*, which sets out safety rules and prohibits the sale of unsafe goods; and the *Sale of Goods Acts*, which govern your contractual relationship with your customer. In addition, the common-law rules of negligence also apply to business dealings.

If you're a principal in a partnership with unlimited liability, a lawsuit concerning product liability is quite likely to bankrupt you. Even if you carry out the business through a limited company, although the directors may escape personal bankruptcy, the company doesn't. If you believe that real risks are associated with your product, then you need to consider taking out product liability insurance.

If your business involves foodstuffs, you must also pay close attention to the stringent hygiene regulations that now encompass all food manufacture, preparation and handling. If you've thoroughly examined and identified all the hazard points yet something unforeseen goes wrong, you can claim the defence of 'due diligence', in so far as you've done everything you could reasonably have been expected to do. Trading Standards (www.tradingstandards.gov.uk) and environmental health officers based in your local government office are there to help and advise in a free consultative capacity.

Producers or importers of certain types of goods face obligations under both the Consumer Protection Act 1987 and the Sale of Goods Act 1979. Importers can be sued for defects; they can't disclaim liability simply because they haven't been involved in manufacture.

Business Link can give you the low-down on this subject. Go to its website at www.businesslink.gov.uk, then click on Sales and Marketing, Selling and the Law and finally The Sale of Goods Act.

Other liabilities you should consider taking insurance cover against are:

- **Public liability:** This is a legal liability to pay damages for bodily injury, illness or disease contracted by any other person, other than employees, or loss of or damage to their property caused by the insured.
- **Professional indemnity:** This provides protection against any legal action by clients who believe they received bad or negligent services, and incurred a loss as a result. Most professional companies have professional indemnity cover – in some industries it's compulsory. Anyone who supplies advice or services such as consultancy should consider professional indemnity insurance.

The main points of liability law in the UK are:

- Don't make claims like 'So simple a child could understand'. You're laying yourself wide open to rebuttal.
- Instructions should be crystal clear both on the packet and on the article if possible.
- Textiles must carry fibre content, labelling and washing instructions.
- Because the Acts cover the European Union, if you're exporting to another country in the Union you must double-check translations. It's now possible, for example, for a German person to sue you as manufacturer in a German court for goods exported to Germany that have a product defect.
- You must keep records for ten years and be ready to institute a product recall operation if necessary.

Dissecting Directors

If you decide to trade as a *limited liability company* (see Chapter 5), then in all probability you have to become a director of the business. You may be the only director, or you may be one of several, but as well as the status you have responsibilities too.

Some of a director's duties, responsibilities and potential liabilities are:

- To act in good faith in the interests of the company; this includes carrying out duties diligently and honestly.
- Not to carry on the business of the company with intent to defraud creditors or for any fraudulent purpose.
- Not knowingly to allow the company to trade while insolvent ('wrongful trading'); directors who do so may have to pay for the debts incurred by the company while insolvent.
- Not to deceive shareholders.
- To have regard for the interests of employees in general.
- To comply with the requirements of the Companies Acts, such as providing what's needed in accounting records or filing accounts.

In practice, a director's general responsibilities are much the same as those for a sole trader or partner (outlined in Chapter 5). By forming a company you can separate your own assets from the business assets (in theory at any rate, unless they're covered by your personal guarantee). However, a director also has to cope with more technical and detailed requirements; for example, sending your accounts to Companies House. More onerous than just signing them, a director is expected and required in law to understand the significance of the balance sheet and profit and loss account and the key performance ratios.

You can insure directors' risks using directors' insurance, which covers negligent performance of duties and breach of the Companies Acts – particularly the Insolvency Act, which can hold directors personally liable to a company's creditors. The company bears the cost of the insurance because the directors are acting on its behalf.

The most dangerous areas of a director's responsibilities are ones that can get you disqualified. In summary the areas to avoid at all costs are:

- Trading while insolvent occurs when your liabilities exceed your assets. At this point the shareholders' equity in the business has effectively ceased to exist, which puts directors personally at risk. Directors owe a duty of care to creditors – not shareholders. If you find yourself even approaching this area you need the prompt advice of an insolvency practitioner. Directors who act properly aren't penalised, and live to fight another day.
- Wrongful trading can apply if, after a company goes into insolvent liquidation, the liquidator believes that the directors ought to have concluded earlier that the company had no realistic chance of survival. In these circumstances the courts can make directors personally liable for the company's debts.
- Fraudulent trading is rather more serious than wrongful trading. Here the proposition is that the director(s) were knowingly party to fraud on their creditors. The full shelter of limited liability can be removed in these circumstances.

Former directors of insolvent companies can be banned from holding office as a company director for periods of up to 15 years. Fraud, fraudulent trading, wrongful trading or a failure to comply with company law may result in disqualification.

A register of disqualified directors is available on the Insolvency Service website (www.insolvency.gov.uk/doitonline/ddbase.htm).

Finding and Choosing Business Advisers

You need lots of help to get started in business and even more when you're successful – and this help can come from accountants, banks, lawyers and management consultants, as well as possibly tax consultants, advertising and public relations consultants, technology and IT advisers, and so on. The rules and tips in the following sections should steer you through dealing with most situations involving choosing and using outside advisers.

Tallying up an accountant

Keeping your financial affairs in good order is the key to staying legal and winning any disputes. A good accountant inside or outside your company can keep you on track. A bad accountant is in the ideal position to defraud you at worst, or to derail you through negligence or incompetence.

What attributes should you look for and how can you find the right accountant for your business? The key steps to choosing a good accountant are:

- Check that the accountant is a member of one of the recognised accounting bodies such as the Chartered Institute of Management Accountants (www.cimaglobal.com) or the Institute of Chartered Accountants in England and Wales (www.icaew.co.uk).
- Have a clear idea of what services you require. You need to consider how complete your bookkeeping records are likely to be, whether you need your VAT returns completed or budgets and cash-flow forecasts prepared

and updated, as well as whether you require an annual audit.

- Clarify the charges scale at the outset. Spending a little more on bookkeeping, both staff and systems, may make more sense than leaving it all to a much higher-charging qualified accountant.
- Use personal recommendations from respected fellow businesspeople, particularly fellow clients of the accountant you're considering. Pay rather less attention to the recommendation of bankers, government agencies or family and friends, without totally ignoring their advice.
- Take references from the accountant's clients as well as from the person who recommended the accountant. They may just get on well – they may even be related!
- Find out what back-up the accountant has for both systems and people. The tax authorities aren't very sympathetic if you're late with your records, whatever the reason. It would be doubly annoying to be fined for someone else's tardiness.
- See at least three accountants before making your choice, ensuring that they deal with companies your size and a bit bigger – not so much bigger that they have no relevant advice and help to offer, but big enough for you to have some room for growth without having to change accountants too quickly.
- Find out which other companies the accountant acts for. You don't want the accountant to be so busy she can't service your needs properly, or to be working for potential competitors.
- Make the accounting appointment for a trial period only, and set a specific task to see how the accountant gets

on.

- Give the accountant the latest accounts of your business and ask for her comments based on her analysis of the figures. You can quickly see whether she's grasped the basics of your financial position.

Investing in a bank

You may wonder why I list selecting a bank in a section covering choosing business advisers. The answer, crazy as it may seem, is that your banker is almost invariably the first person you turn to when the chips are down. You may not find this so surprising when you think about it. After all, most big business problems turn on money and bankers are the people who turn the money on.

Go for the wrong bank and you can lose more than your overdraft. You may lose the chance to acquire a free, or at least nearly free, business adviser.

The top ten questions to ask before taking on a bank manager are:

- How quickly can you make decisions about lending? Anything longer than ten days is too long.
- What rate of interest do you charge? Around 2 or 3 per cent above the Bank of England base rate is fairly normal. Above 4 per cent is on the high side.
- What factors do you take into consideration in arriving at that rate? If the bank proposes a high rate of interest, say 4 per cent above the Bank of England base rate or higher, then you need to know why. It may be that all the

bank is asking for is some further security for its loan, which you may think worth giving in return for a lower interest rate.

- What other charges are there? For example, does the bank charge for every transaction in and out of an account and if so how much?
- Do you visit your clients and get to know their business? If the bank doesn't visit, how can it ever get to understand your business in depth?
- Under what circumstances does the bank want a personal guarantee? When the bank is feeling exposed to greater risk than it wants to take, it may ask you to shoulder some of that risk personally. Under the terms of a bank's loan to your business, it may state that its lending shouldn't exceed a certain sum. You need to be clear what that sum is.
- What help and advisory services do you have that may be useful to me? Banks often provide advice on export trade, currency dealing, insurance and a range of other related services.
- What's unique about your banking services that may make me want to use you rather than any other bank? This factor rather depends on what you consider to be valuable. A bank that delivers all its services on the Internet may be attractive to one person and anathema and a turnoff to another.
- How long may it be before my present manager moves on? If the bank routinely moves managers every few years, forming personal relationships may not be particularly valuable.
- Do any situations exist when you're likely to ask for early repayment of a loan? A bank may insist that if you break

any major condition of the loan, such as the overdraft limit or repayment schedule, the whole loan is repayable. You need to find out whether this is so, and what sum or event may cause this to happen.

Soliciting for a lawyer

Lawyers or solicitors are people you hope never to have to use and when you do need one you need her yesterday. Even if you don't appoint a company lawyer, you may well require one for basic stuff if you're forming a company or setting up a partnership agreement. Follow the same rules as you do for choosing an accountant (refer to 'Tallying up an accountant', earlier in this chapter).

The fact is that in business, one day you're going to need a lawyer. The complexity of commercial life means that sooner or later you may find yourself either initiating or defending legal action. It may be a contract dispute with a customer or supplier, or perhaps the lease on your premises turns out to give you far fewer rights than you hoped. A former employee may claim that you fired her without reason. Or the health and safety inspector may find some aspect of your machinery or working practices less than satisfactory.

When things do go wrong, the time and money required to put them right can be an unexpected and unwelcome drain. By doing things right from the start, you can avoid at least some of the most common disputes and cope more easily with catastrophes.

In addition to ensuring that contracts are correctly drawn up, that leases are free from nasty surprises and that you're following the right health and safety procedures, a solicitor can also advise on choosing the best structure for your company, on protecting your intellectual property and on how to go about raising money.

It makes sense either to see your solicitor before your problems arise and find out what she can do for you, or, at the very least, to make yourself conversant with the relevant laws. Taking timely action on legal issues may help you gain an advantage over competitors and almost certainly saves you money in the long run.

If you're going to see a lawyer, it's always best to be well prepared. Have all the facts to hand and know what you want help with.

Managing a consultant

If you're facing a new major problem in which you have no expertise, particularly a problem you don't expect to experience again, then hiring a consultant is an option worth considering. For example, if you're moving premises, changing your computing or accounting system, starting to do business overseas or designing an employee share ownership scheme, getting the help of someone who's covered that area several times before and who's an expert in the field may well make sense.

Finding a lawyer for your business

Lawyers For Your Business (www.lawsociety.org.uk; select Find a Solicitor and then Lawyers For Your Business) represents some 1,400 firms of solicitors in England and Wales that have come together to help ensure that all businesses, especially the smaller owner-managed ones, get access to sound legal advice whenever they need it.

To remove the risk of incurring unexpectedly high legal costs, all Lawyers For Your Business members offer a free consultation, lasting at least half an hour, to diagnose your legal problem and any need for action, with full information, in advance, on the likely costs of proceeding.

The Law Society (www.lawsociety.org.uk) can send you a list of Lawyers For Your Business members in your area, and a voucher for a free consultation. Simply choose one of the firms in the list and arrange an appointment, mentioning Lawyers For Your Business and the voucher.

REMEMBER The time a consultant takes to carry out most tasks a small business may require is likely to be between a fortnight and three months. Anything much longer is too expensive for most small firms and anything much shorter is unlikely to have much of an impact on the business. However, the consultant isn't working continuously on your project for that time. After an initial meeting, a consultant may do much of the work off site and in chunks of time. Costs vary depending on both the skill of the consultant and the topic covered. A tax consultant, for example, can cost upwards of £450 an hour, and a training consultant may cost the same sum for a day.

Take on a consultant using much the same procedures as for a key employee (see Chapter 11). Take time to brief the consultant thoroughly. Don't expect just to dump the problem on the consultant's doorstep and walk away. Set the consultant a small, measurable part of the task first and see how she performs. Never give the consultant a long-term contract or an open-ended commitment.

REMEMBER You can't delegate decision making, you can only delegate the analysis of problems and the presentation of options. In the end, you have to choose which way to go. Don't let consultants implement decisions on their own. The line of responsibility between yourself and your staff needs to be preserved. Seeing someone else giving orders undermines the chain of command. If the consultant's solution is so complex it needs her expertise to implement, you have the wrong solution.

The Institute of Business Consulting (www.ibconsulting.org.uk) provides guidelines for choosing a consultant in the Purchasing Consultancy section of its website. You may also find that your local Business Link has a register of approved (and insured) specialist consultants for most business needs (find more information at www.businesslink.gov.uk).

Chapter 13

Keeping Track of Finances

In This Chapter

- Keeping essential records
- Understanding the main accounting reports
- Analysing financial data
- Meeting profit goals
- Evaluating financial performance
- Staying on the right side of the law

Every business needs reliable financial information for both decision making and accountability. No one is going to be keen to pump money into your venture if you can't demonstrate that you know what's likely to happen to it. Reliable information doesn't necessarily call for complex bookkeeping and accounting systems: simple is often best. As the business grows, and perhaps takes on outside investors, you require more sophisticated information. That's when using a computer and some of the relevant software packages may be the best way forward. But even with a computer errors can occur, so you have to know how to recognise when financial information goes wrong and how you can correct it.

You have a legal obligation in business to keep accounting records from the outset and not just wait until your business runs into serious problems. If as a director or owner of a business you can't see when you're heading for a financial reef, you may find yourself in deep trouble, if not actually heading for jail – and definitely not collecting £200 on the way.

Keeping the Books

To survive and prosper in business you need to know how much cash you have, and what your profit or loss on sales is. You need these facts on at least a monthly, weekly or occasionally even a daily basis to survive, let alone grow.

Recording financial information

Although bad luck plays a part in some business failures, a lack of reliable financial information plays a part in most. However, businesses have all the information they need to manage well close at hand. Among the bills you have to pay, invoices to raise, petty cash slips to file and bank statements to diagnose, you have enough to give you a true picture of your business's performance.

All you need to do is record and organise that information so that the financial picture becomes clear. The way you record financial information is called *bookkeeping*.

Not only the business owner needs these financial facts. Bankers, shareholders and tax inspectors are unsympathetic audiences to anyone without well-documented facts to back them up. If, for example, a tax authority presents a business with a tax demand, the onus then lies with the businessperson, using his records, either to agree or dispute the sum claimed.

In any event, if you plan to trade as a limited company (see Chapter 5), the Companies Act 1985 requires you 'to keep adequate records sufficient to show and explain the company's transactions'.

Reasons for keeping proper records:

- To know the cash position of your business precisely and accurately
- To discover how profitable your business really is
- To see which of your activities are profitable and which aren't
- To give bankers and other sources of finance confidence that your business is being well managed and that their money is in good hands
- To allow you to calculate your tax bill accurately
- To help you prepare timely financial forecasts and projections
- To make sure that you both collect and pay money due correctly
- To keep accountancy and audit costs to a minimum

Starting simple with single entry

If you're doing books by hand and don't have a lot of transactions, the single-entry method is the easiest acceptable way to go.

Single entry means that you write down each transaction in your records once, preferably on a ledger sheet. You record the flow of income and expenses through your business by making a running total of money taken in (gross receipts) and money paid out (payments or, as they're sometimes called, *disbursements*). You should keep receipts and payments and summarise them daily, weekly or monthly, as the business needs require. At the end of the year, you total up the 12 monthly summaries. You're ready for tax time.

You may benefit from separating different types of income and expense into categories, for example stock, vehicles, telephone, as in Figure 13-1. This lets you see how much you're spending or receiving in each area.

Figure 13-1: An example of an analysed cash book.

Payments				*Analysis*			
Date	*Name*	*Details*	*Amount £*	*Stocks*	*Vehicles*	*Telephone*	*Other*
4 June	Gibbs	Stock purchase	310	310			
8 June	Gibbs	Stock purchase	130	130			
12 June	ABC Telecoms	Telephone charges	55.23			55.23	
18 June	Colt Rentals	Vehicle hire	87.26		87.26		
22 June	VV Mobiles	Mobile phone	53.24			53.24	
27 June	Gibbs	Stock purchase	36.28	36.28			
Totals			672.01	476.28	87.26	108.47	

You need to keep copies of paid and unpaid sales invoices and the same for purchases, as well as your bank statements. You then 'reconcile' (match) bank statements to your cash book to tie everything together.

If you're taking credit from suppliers or giving credit to customers, then you need to keep information on such matters as how long the money has been owed and what interest penalties, if any, will be applied to late payments, as well as the cash book, whether you analyse it or not.

Dealing with double entry

If you operate a partnership or trade as a company, then you may need a double-entry bookkeeping system from the start.

A *double-entry bookkeeping system* requires two entries for each transaction – hence the name – and every transaction has two effects on the accounts. For example, when you buy an item of stock for sale and pay for it in cash, your cash balance goes down and your amount of stock goes up by the same amount, keeping everything in balance.

Choosing the right accounting program

With the cost of a basic computerised accounting system starting at barely £50, and a reasonable package costing between £200 and £500, planning to use such a system from the outset is sensible. If you're at all concerned as to whether such software represents value try out Intuits SimpleStart (http://quickbooks.intuit.co.uk). It's completely free for ever. The only catch is that although it's a fully functioning accounting package, you're limited to just 20 customers and suppliers.With a computer you have no more arithmetical errors. As long as you enter the information correctly, the computer adds it up correctly. With a computer, the £53.24 mobile phone expenditure in Figure 13-1 is input as an expense (a debit), and then the computer automatically posts it to the mobile phone account as a credit. In effect, the computer eliminates the extra step or the need to master the difference between debit and credit.

A computerised accounting program is only as good as the data you enter into it. Introduce strict end-of-month controls to make sure that you've counted and valued all stock, that you've dealt with all the month's invoices and so on. Without this, your computer program reflects inaccurate data.

Routine tasks, such as filling in tax and value added tax (VAT) returns, take minutes rather than days with a computer. The system can ensure that your returns are accurate and fully reconciled. With a computerised system, invoices are always accurate. You can see at a glance which customers regularly take too long to pay.

You have two main options in your choice of your first accounting system. If you think that a manual system is best for your purposes, you can get sheets of analysis paper with printed columns for accounting entries, and put in your own headings as appropriate. Or you can buy off-the-shelf manual sets of books from any office stationer's outlet. These cost anything from £10 to £20 for a full set of ledgers. Hingston Publishing (www.hingston-publishing.co.uk) produces small business accounts systems for both VAT and non-VAT registered businesses for about £15.

If you decide to take the plunge and go straight for accounting software, then you have a myriad of software providers to choose from that serve the small business market with software for bookkeeping. These are some of the more popular packages:

- MYOB (Mind Your Own Business; www.mamut.com/uk/myob) offers a range of bookkeeping systems starting with its Mamut Office Mini licensed out at £59 per annum and going up to Mamut Enterprise E5, costing £408 per annum.
- TAS Books Small Business Edition (SBE; www.tassoftware.co.uk) is aimed specifically at the needs of new, smaller companies. Online support within the product is generally comprehensive, and a manual helps to explain more advanced features. It offers a basic

system for free and then a range of more sophisticated ones on yearly subscriptions from around a £100.

- QuickBooks (www.intuit.co.uk) offers a range of products from £99 to £499. The most sophisticated of its products has budgeting, forecasting and an advanced reporting too where you can choose from over 135 templates, or build your own advanced reports.)
- Sage's (http://shop.sage.co.uk/accountssoftware.aspx) entry product Sage Instant Accounts v16, which comes in at about £135, bears reasonable comparison with some of the other products on the market. Sage 50 Accounts 2011 is a heavy-duty program weighing in at a correspondingly hefty £650.

Outsourcing bookkeeping

Accountants and freelance bookkeepers can do all your bookkeeping work – at a price. The rate is anything from £20 per hour upwards.

Bookkeeping services range from a basic write-up of the entries and leave-the-rest-to-you approach, through to providing weekly or monthly accounts, perhaps with pointers as to what may be going wrong. Services even exist that act as a virtual finance director, giving you access to a senior accountant who may sit on your board.

Most bookkeeping services have a computer system into which you have to plug your records, so if you're thinking of going down this route check out which software you require first.

The bookkeeper's most routine but vital task may be doing the payroll. If you don't get this done on time and correctly, both staff and HM Revenue and Customs, for which you have to collect pay as you earn (PAYE), becomes restless. A weekly payroll service for up to ten employees costs upwards of £85 per month. If you pay everyone monthly, the cost drops to about a third of that figure.

If you go down this route you probably need someone local, so ask around to find someone who uses a bookkeeper and is satisfied. Alternatively, turn to the phone book.

As with an accountant, make sure that a prospective bookkeeper is adequately qualified. The International Association of Book-keepers (IAB; website www.iab.org.uk; tel. 01732 458080) and the Association of Certified Bookkeepers (ACB; tel. 0208 749 7126) are the two professional associations concerned.

TIP You can check out the letters that anyone in the accounting profession uses after his name or the bodies he claims to be a member of at the Directory of Essential Accountancy Abbreviations, which the Library and Information Service at the Institute of Chartered Accountants in England and Wales maintains (www.icaew.com; go to Library and then A–Z).

Understanding Your Accounts

Keeping the books is one thing, but being able to make good use of the information those accounts contain is quite another. You need to turn the raw accounting data from columns of figures into statements of account. Those accounts in turn tell you how much cash your business has, its profit or loss numbers and how much money you have tied up in the business to produce those results. The following sections discuss some of the key accounting statements and performance analyses.

Forecasting Cash Flow

In the language of accounting, income is recognised when a product or service has been sold, delivered or executed, and the invoice raised. Although that rule holds good for calculating profit (see ‘Reporting Your Profits’, later in this chapter), it doesn’t apply when forecasting cash flow.

Chapter 8 covers how to prepare a cash-flow forecast. Profit is what may be generated if all goes well and customers pay up, and you can think of cash flow as the cold shower of reality, bringing you sharply back to your senses.

Overtrading describes a business that’s expanding beyond its financial resources. As sales expand, the amount of cash tied up in stocks and customers’ credit grows rapidly. Pressure also comes from suppliers of goods and services and from additional employees, who all expect to be paid. The natural escape valve for pressures on working capital is an overdraft (or a substantial increase in the existing one). Monitoring cash flow reduces the risk of overtrading.

Reporting Your Profits

A key use of bookkeeping information is to prepare a profit and loss account.

In carrying out any business activity, two very different actions go on. One is selling your goods and services and getting paid for them. Money comes in – perhaps not immediately, but it usually shows up eventually. This money goes by a variety of names, including *revenues*, *income* and *sales income*. The second transaction is the outlay you make in order to provide the goods and services you sell to your customers. Some of the costs you incur are for raw materials, salaries, rents and so forth. These costs are known as *expenses*. By deducting your expenses from your income, you end up with the profit (or loss) for the particular period under review.

At its simplest, the profit and loss account has at its head the period covered, followed by the income, from which you deduct all the expenses of the business to arrive at the profit (or loss) made in the period. Figure 13-2 shows a sample account.

Figure 13-2: A basic profit and loss account.

Profit and Loss Account for year to 31 March 201X	£
Income	1,416,071
Less expenses	1,389,698
Profit	26,373

Although the information shown in the profit and loss account is certainly better than nothing, you can use basic bookkeeping information to give you a much richer picture of events within the business. Provided, that is, that you've set up the right analysis headings in the first place.

The following sections show, step by step, how to build up a profit and loss account to give you a more complete picture of the trading events of the past year at Safari Europe, the example I use in the following sections.

Calculating gross profit

One of the most important figures in the profit and loss account is the gross profit. Whatever your activity, you have to buy certain 'raw materials'. Those include anything you have to buy to produce the goods and services you're selling. So if you sell cars, the cost of buying in the cars is a raw materials cost. In Safari's case, because the company is in the travel business, the costs of airline tickets and hotel rooms are the raw material of a package holiday.

The amount left from the sales revenues after deducting the cost of sales, as these costs of 'making' are known, is the *gross profit*. This is really the only discretionary money coming into the business, where you have some say over how it's spent. Figure 13-3 shows a sample profit calculation.

In the account shown in Figure 13-3 you can see that Safari has two sources of income, one from tours and one from insurance and other related services. It also, of course, has the costs associated with buying in holidays and insurance policies from suppliers.

The difference between the income of £1,416,071 and the cost of the 'goods' the company has sold is just £160,948. That's the sum that the management has to run the business, not the much larger headline-making figure of nearly £1.5 million.

Figure 13-3: An example of gross profit calculation.

Safari Europe	
Profit and Loss Account for year to	31 March 201X
Income	
Tours sold	1,402,500
Insurance & other services	13,571
Non-operating revenue	0
Total income	1,416,071
Less **Cost of goods sold**	
Tours bought	1,251,052
Insurance & other services	4,071
Total cost of goods sold	1,255,123
Gross profit	160,948

Figure 13-4 shows how to calculate gross profit in a business that makes things rather than selling services.

Figure 13-4: A manufacturer's gross profit.

	£
Sales	100,000
Cost of goods sold	65,000
Gross profit	35,000

In the example in Figure 13-4, the basic sum is the same as for a service business, as shown in Figure 13-3. Take the cost of goods from the sales income and what's left is gross profit. However, a business that makes things holds raw materials, and you only want to count in the cost of goods sold the materials actually used. You do this by noting the stock at the start of the period, adding in any purchases made and deducting the closing stock.

You also need to build in the labour cost in production and any overheads, such as workshop usage, and deduct those in order to arrive at the gross profit, as shown in Figure 13-5.

Reckoning expenses

After you calculate the gross profit, you have to allow for all the expenses that are likely to arise in running the business. Using the Safari case as a working example, Figure 13-6 shows all the costs usually associated with running the business, such as rent, rates, telephone, marketing and promotion, and so forth. Although all these expenses are correctly included, they aren't all allowable for tax purposes in all countries. I look at taxation in Chapter 14.

The Total expenditure heading isn't quite accurate. Other expenses associated with running a business aren't included here, but these expenses are treated in a slightly different way, for reasons that will become apparent as you read on about the different types of profit.

Figure 13-5: Expanded gross profit calculation.

	£	£	£
Sales			**100,000**
Manufacturing costs			
Raw materials opening stock	30,000		
Purchases in period	25,000		
	55,000		
Less Raw materials closing stock	15,500		
Cost of materials used		39,500	
Direct labour cost		18,000	
Manufacturing overhead cost			
Indirect labour	4,000		
Workshop heat, light and power	3,500		
Total manufacturing costs		7,500	
Cost of goods sold			65,000
Gross profit			35,000

Appreciating the different types of profit

You can measure profit in several ways:

- **Gross profit** is the profit left after you've deducted all costs related to making what you sell from income (see the beginning of this section, 'Reporting Your Profits', for what represents income).
- **Operating profit** is what's left after you take the expenses (or expenditure) away from the gross profit.
- **Profit before tax** is what you get after deducting any financing costs. This is a measure of the performance of the management, which is important if the owners and managers aren't the same people, as may be the case when you start to employ staff. The reasoning here is that the operating management can have little influence over the way in which the business is financed (no borrowings means no interest expenses, for example), or the level of interest charges.

Figure 13-6: Business expenses.

Safari Europe	
Profit and Loss Account for the year to 31 March 201X	
	Year 1
Income	
Tours sold	1,402,500
Insurance & other services	13,571
Non-operating revenue	0
Total income	1,416,071
***Less* Cost of goods sold**	
Tours bought	1,251,052
Insurance & other services	4,071
Total cost of goods sold	1,255,123
Gross profit	160,948
Expenditure	
Rent & rates	18,000
Heat, light & power	3,500
Telephone system lease	2,000
Computer leasing	5,000
Marketing & promotion	12,500
Postage & stationery	3,250
Telephone	3,575
Insurance & legal	3,500
Wages (not owner's)	36,000
Consultancy services	25,000
Membership & subscription	1,500
Travel & subsistence	4,250
Training & staff development	6,000
Depreciation of fixtures	5,500
Total expenditure	129,575

Interestingly enough, when it comes to valuing the business, the operating profit is generally used as the multiplying factor (so many times earnings is a typical valuation mechanism and operating profit is used to represent earnings).

Taking away the financing costs, in the example £5,000 interest charges, leaves a profit before tax of £26,373, as shown in Figure 13-7. Finally, you deduct tax to leave the net profit after tax, the bottom line. This sum belongs to the owners of the business and, if it's a limited company, is what dividends can be paid from.

Figure 13-7: Levels of profit.

Safari Europe

Profit and Loss Account for the year to 31 March 201X	
Income	
Tours sold	1,402,500
Insurance & other services	13,571
Non-operating revenue	0
Total income	1,416,071
***Less* Cost of goods sold**	
Tours bought	1,251,052
Insurance & other services	4,071
Total cost of goods sold	1,255,123
Gross profit	160,948
Expenditure	
Rent & rates	18,000
Heat, light & power	3,500
Telephone system lease	2,000
Computer leasing	5,000
Marketing & promotion	12,500
Postage & stationery	3,250
Telephone	3,575
Insurance & legal	3,500
Wages (not owner's)	36,000
Consultancy services	25,000
Membership & subscription	1,500
Travel & subsistence	4,250
Training & staff development	6,000
Depreciation of fixtures	5,500
Total expenditure	129,575
Operating profit	31,373
Less interest charges	5,000
Net profit before tax	26,373
Tax	5,538
Net profit after tax	20,835

Accounting for Pricing

Setting a selling price for your wares is one of the most important and most frequent business decisions that anyone running a business has to make. At first glance it doesn't seem such a big deal. Just add up all the costs, add a healthy profit margin and as long as the customers don't rush for the exit you're in business. Unfortunately, the first part of that sentence contains a few traps for the unwary.

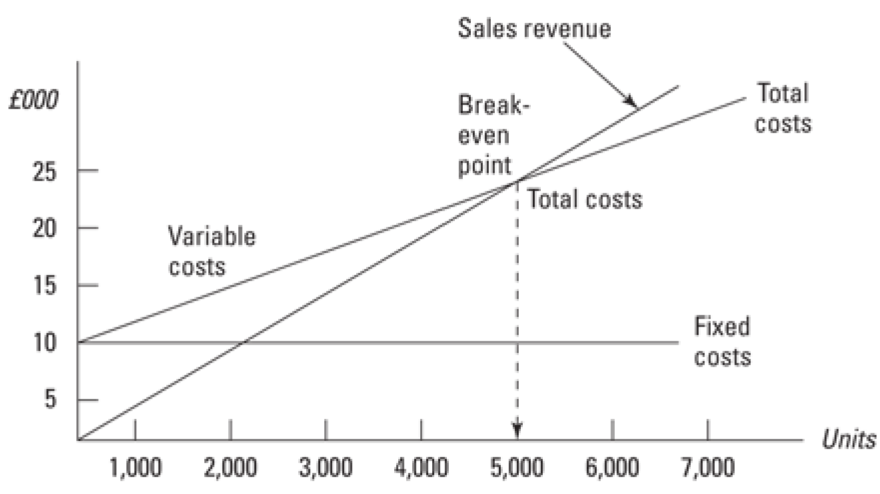
Complications start when you have to get to grips with the characteristics of costs. Not all costs behave in exactly the same way. For example, the rent on a shop, office or workshop is a fixed sum, payable monthly or quarterly. Your landlord doesn't usually expect you to pay more rent if you get more customers, nor is he especially generous if you have a particularly lean period. (One exception to this rule comes if you're able to negotiate a rent geared to performance, an offer landlords have been known to make to some retailers.) The business rates on any premises and the cost of an advertisement in the local paper are also *fixed costs*. That term shows that the cost in question doesn't vary directly with the volume of sales, not that the cost itself has been immutably settled and you're committed to pay it. You don't have to advertise and you do have to pay business rates, but both are fixed costs.

Contrast that with the cost of the products you plan to sell. Assume for a moment that you're selling just one product, a bottle of wine costing £3 to buy in. The more you sell, the more your stock costs to buy. That type of cost varies directly with the volume of sales you achieve, and in a rare display of user-friendliness from the accounting profession is known as *variable*. The cost of each individual bottle may or may not vary – your supplier may or may not change the price, perhaps lowering it to win more business from you or upping it to meet the chancellor of the exchequer's ever-growing demand for more tax. But the nature of the cost means that the total cost does vary as your sales volume changes.

Breaking even

To keep things simple: your business plans to sell only one product, the wine I mention in the previous text, and you only have one fixed cost, the rent. Figure 13-8 sets out a graphical picture of how your costs stack up. The vertical axis shows the value of sales and costs in £'000s and the horizontal axis the number of units sold, in this case bottles of wine. The rent is £10,000 for the year, represented by a straight line labelled 'fixed costs'. The angled line running from the top of the fixed costs line shows the amount of the variable costs. Sell zero bottles and you incur zero additional costs. In this case the total costs are £10,000 plus £0 = £10,000. Every bottle you buy in adds £3 of variable costs (you have to buy the wine in!!) to the total costs.

Figure 13-8: Break-even chart.



You need to calculate the break-even point – that is, when you've made enough money from selling wine to pay the rent. The sales revenue line moves up at an angle from the bottom left-hand corner of the graph. If you plan to sell your wine at £5 a bottle, you calculate the figures for this line by multiplying the number of units sold by that price.

The break-even point is the stage at which a business starts to make a profit – when the money coming in from sales is higher than the fixed and variable costs added together. For your wine business, you can see from the chart that this point arises when you've sold 5,000 bottles. You don't have to draw a chart every time you want to work out your break-even point – you can use a simple formula.

$$\text{Break-even point} = \frac{\text{Fixed costs}}{\text{Selling price} - \text{Unit variable cost}}$$

$$= \frac{10{,}000}{5 - 3} = 5{,}000 \text{ units}$$

Pricing for profit

You have to break even if you want to remain in business, but doing so isn't enough on its own. You need to make a profit over and above your break-even point.

Profit isn't an accident of arithmetic discovered by your accountant at the year end. Profit should be a specific, quantified goal that you set in advance. Look again at the earlier wine selling example: you plan to invest £10,000 in a year's rent, and you need to hold at least £5,000 worth of stock too, making £15,000 total costs. So what return can you expect on the money you're investing? If you invested the same amount in other people's businesses by buying an average bundle of shares on the stock market, you may expect to get a return of £1,200, around 8 per cent. If you went for more risky start-up and early-stage ventures, a venture capital firm may recommend you to look for a return of between 20 and 30 per cent.

To keep the numbers simple again, say your profit goal is to make £4,000 profit, a return of 27 per cent (4,000 ÷ 15,000 × 100). How many bottles of wine do you need to sell to break even and meet your profit goal? The new equation must include your desired profit, so it looks like this:

$$\text{Break-even profit point (BEPP)} = \frac{\text{Fixed costs + Profit goal}}{\text{Selling price} - \text{Unit variable cost}}$$

$$= \frac{10{,}000 + 4{,}000}{5 - 3} = \frac{14{,}000}{2} = 7{,}000$$

From the formula, you now know that to reach your profit goal you have to sell 7,000 bottles of wine. Better still, this powerful little equation allows you to change each element and experiment to arrive at the optimum result. For example, say that after doing some market research you conclude that you're unlikely to sell 7,000 bottles of this wine, but that you can sell 6,000. What does your selling price have to be to make the same profit?

Using the BEPP equation and inserting '*x*' for the element you're changing, you can calculate the answer:

$$\text{Break-even profit point (BEPP)} = \frac{\text{Fixed costs + Profit goal}}{\text{Selling price} - \text{Unit variable cost}}$$

$$= 6{,}000 = \frac{10{,}000 + 4{,}000}{x - 3}$$

$$\text{Therefore } x - 3 = \frac{10{,}000 + 4{,}000}{6{,}000} = 2.33$$

$$x = 3 + 2.33 = \; = 5.33$$

So your new selling price has to be £5.33 a bottle if you need to make £4,000 profit from the sale of 6,000 bottles. If the market can bear that price, great; if not, then you need to look for ways to decrease the fixed and variable costs, or to sell more, if you're to meet your profit goal.

Working with that formula may have frightened you if your algebra is a bit rusty! You have two options. The easy one is to use a spreadsheet to take the pain out of the number crunching. Using a spreadsheet gives you a further advantage. So far you've only been working with one fixed cost and one variable cost; in practice you obviously have many more, and using a spreadsheet makes changing the calculation much easier. Harvard Business School offers a free downloadable interactive break-even workbook (http://hbswk.hbs.edu/archive/1262.html), one of several workbooks/tutorials from the HBS Toolkit used by its students. Bankrate, a leading aggregator of financial rate information, also has a number of financial spreadsheets on its website including a neat tool for working out your break-even point (www.bankrate.com/brm/news/biz/Cashflow_banking/breakeven.XLT). And your second option? If you're a glutton for punishment and want to do the sum yourself, boost your algebra at the BBC's Bitesize site (www.bbc.co.uk/schools/gcsebitesize/maths).

Building in more products

The example so far has been for a one-product company, but what if you plan to sell more than just one type of wine – or perhaps even add crisps and chocolates too? When you reach this stage you need to work from your gross profit percentage (for how to calculate this see ‘Analysing Performance’, later in this chapter).

If, for example, you’re aiming for a 40 per cent gross profit, your fixed costs are £10,000 and your profit goal is £4,000, then the sum is as follows:

$$\text{BEPP} = \frac{10{,}000 + 4{,}000}{0.4} = \frac{14{,}000}{0.4} = £35{,}000$$

If you got a bit lost about where the 0.4 came from, don’t worry; that’s just 40 per cent expressed as a decimal, a step you need to take before you can use the number. What you now know is that at a 40 per cent gross profit margin you need to sell £35,000 worth of wine, chocolates and crisps to hit your profit goal. Your accountant can help with these calculations, and the Harvard Business School website has a useful tutorial that links with its break-even spreadsheet.

Handling price changes

The most sensitive and revisited area of business strategy is pricing. You can check out the impact of a particular pricing policy on your profitability using break-even analysis (see ‘Pricing for profit’, earlier in this chapter, for more details). As part of your strategy you may consider changing your price. All things being equal, a lower price should open up a bigger market and so increase sales. But should you reduce your price?

As a rule of thumb, if you decrease your prices by 5 per cent you have to increase your sales by three times that percentage, just to make the same level of profit. This depends on the gross profit you're achieving, but the figure given holds good for gross profits of 30 to 40 per cent.

Conversely, if you push your prices up by 5 per cent, you can lose around a seventh of your business before you're any worse off in terms of profit.

BizPep has a useful piece of software that allows you to calculate your optimal selling price under a wide range of business conditions (www.bizpeponline.com/PricingBreakeven.html). A fully functioning download is available free for a seven-day trial. The outputs include break-even charts for current, increased, decreased and optimum pricing calculated for prices ranging from –50 to +50 per cent of your current actual or proposed price. You can carry out the same analysis yourself using the free software from the Harvard Business School (see the earlier section 'Pricing for profit'), but BizPep's templates do some of the grunt and groan for you.

Balancing the Books

You have to know where you are now before making any plans to go anywhere else. Without a starting point any journey is bound to be a confusing experience. A business sums up its current position in a balance sheet, the business's primary reporting document. The balance sheet contains the cumulative evidence of financial events, showing where money has come from and what's been done with that money. Logically, the two sums must balance.

In practical terms, balancing your sums takes quite a bit of work, not the least of which isn't necessarily the balancing part, but figuring out the numbers. Your cash-in-hand figure is probably dead right, but can you say the same of the value of your assets? Accountants have their own rules on how to arrive at these figures, but they don't pretend to be anything more than an approximation. Every measuring device has inherent inaccuracies, and financial controls are no exception.

A balance sheet

In formal accounts the figures are set out vertically rather than in horizontal fashion, reflected in Figure 13-9. The business's long-term borrowings, in this case the mortgage and hire purchase charges, are named *Creditors, amounts falling due in over 1 year* and deducted from the total assets to show the *Net total assets* being employed.

The bottom of the balance sheet in Figure 13-9 shows how the owners of the business have supported these assets, in this case by their own funds. As you can see later, they could also have invested profit made in earlier years back into the business (see the later section 'Understanding reserves'). I've also assumed that the owner's house is now a business premises owned by her company. (This assumption has wider implications, but none that's relevant to the arithmetic or the balance sheet.)

Figure 13-9: Jane Smith Limited Balance Sheet at 5 April, 201X.

	£	£
NET ASSETS EMPLOYED		
Fixed assets		
Premises	150,000	
Car	7,000	
Furniture	1500	
Jewellery and paintings	350	
Book value		158,850
Current assets		
Money owed by sister	135	
Cash	50	
Total current assets	185	
Less Current liabilities		
Overdraft	100	
Credit cards	50	
Total current liabilities	150	
Net current assets		35
Total assets		158,885
Less: Creditors, amounts falling due in over 1 year		45,500
Net total assets		***113,385***
FINANCED BY		
My capital	113,385	
Total owners' funds		113,385

Categorising assets

Accountants describe *assets* as valuable resources, owned by a business, which were acquired at a measurable monetary cost.

The exception to the *paid for* part is the grey area of goodwill. *Goodwill* is the value placed on the business's reputation and other intangible assets – a brand name, for example. Assessing the value of this asset is of particular interest to those buying or selling a business.

One useful convention recommends listing assets in the balance sheet in their order of permanence; that is, starting out with the most difficult to turn into cash and working down to cash itself. This structure is very practical when you’re looking at someone else’s balance sheet, or comparing balance sheets. It can also help you to recognise obvious information gaps quickly.

Accounting for liabilities

Liabilities are claims against the business. These claims may include such items as tax, accruals (which are expenses for items used but not yet billed for, such as telephone and other utilities), deferred income, overdrafts, loans, hire purchase and money owed to suppliers. Liabilities can also be less easy to identify and even harder to put a figure on, bad debts being a prime example.

Understanding reserves

Reserves are the accumulated profits that a business makes over its working life, which the owner has ploughed back into the business rather than taking them out.

Jane Smith’s balance sheet (see the earlier section ‘A balance sheet’) shows her capital as being the sole support for the liabilities of the business. The implication is that she put this whole sum in at once. In practice, this is much more likely to have happened over time, and in a variety of ways.

Perhaps she started out in business, because that is how you must now look at her affairs, with a sum of, say, £25,000. In the period since she’s been in business she’s made a net profit after tax of £50,000 and put this back into her business to finance growth. In addition, the premises that she bought a few years ago for £111,615 have just been revalued at £150,000, a paper gain of £38,385.

The bottom portion of her company balance sheet may now look as shown in Figure 13-10.

Figure 13-10: Jane's reserves.

	£	£
FINANCED BY		
Capital introduced		25,000
Reserves		
Capital reserve	38,385	
Revenue reserve	50,000	88,385
		113,385

The profit of £50,000 ploughed back into the business is called a *revenue reserve*, which means that the money actually exists and can be used to buy stock or more assets. The increase in value of the business premises is, on the other hand, a *paper* increase. Jane can't use the £38,385 increase in *capital reserves* to buy anything, because it's not in money form until the premises are sold. However, she can use that paper reserve to underpin a loan from the bank, so turning a paper profit into a cash resource. Both reserves and the capital introduced represent all the money that the shareholder has invested in this venture.

Analysing Performance

Gathering and recording financial information is a lead-up to analysing a business to see how well (or badly) it's doing. This analytical process requires tools, in this case ratios, and you need to understand their usefulness and limitations before you can use them to good effect.

Using ratios

All analysis of financial information involves comparisons. Because a business is constantly changing, the most useful way to measure activity is through ratios. A *ratio* is simply one number expressed as a proportion of another. Travelling 100 miles may not sound too impressive, until you realise it took one hour. The ratio here is 100 miles per hour. If you know that the vehicle in question has a top speed of 120 miles per hour, you have some means of comparing it to other vehicles, at least in respect of their speed. In finance, too, ratios can turn sterile data into valuable information in a wide range of different ways and help you make choices.

I describe the key financial ratios you need from the outset in the following sections. Monitor all these at least on a monthly basis.

Gross profit percentage

To calculate gross profit percentage, you deduct the cost of sales from the sales and express the result as a percentage of sales. The higher the percentage, the greater the value you're adding to the goods and services you're producing. Figure 13-11 shows the calculation.

$$\text{Gross profit percentage} = \frac{\text{Profit}}{\text{Sales} - \text{Cost of sales}} \times 100$$

Figure 13-11: Formula for calculating gross profit percentage.

Operating profit percentage

Calculating the operating profit percentage gives you a measure of how well the management is running the business, because operating expenses for which the management is responsible form a component of the calculation. Financing decisions are presumed to be the owner's responsibility; interest and taxation are set by the government, so those numbers are out of management control and accountability.

To calculate this number, you deduct from profit not only the cost of sales but also expenses, as Figure 13-12 shows.

$$\text{Operating profit percentage} = \frac{\text{Profit}}{\text{Sales} - (\text{Cost of sales} + \text{Cost of operations})} \times 100$$

Figure 13-12: Calculating operating profit.

Net profit percentage

Working out your net profit essentially gives you your business's *bottom line,* telling you how much money is left for you to take out, or reinvest in your business. A higher percentage means that you're making more money from each pound of sales generated.

You can calculate net profit either after you pay tax or before – earnings before interest and tax, known as EBIT.

In its after-tax form, which Figure 13-13 shows, net profit percentage represents the sum available for the business either to distribute as dividends or retain to invest in its future.

$$\text{Net profit percentage} = \frac{\text{Profit}}{\text{Sales} - (\text{Cost of sales} + \text{Cost of operations} + \text{Taxes paid})} \times 100$$

Figure 13-13: Calculating net profit percentage.

Return on capital employed

This number, frequently abbreviated to ROCE, is the primary measure of performance for most businesses. If, for example, you invested £10,000 in a bank and at the end of the year it gave you £500 interest, then the return on your capital is 5 per cent (£500 ÷ 10,000 × 100 = 5 per cent).

A business calculates this ratio by expressing the operating profit (profit before interest and tax) as a percentage of the total capital employed – both in fixed assets and in working capital, called *net current assets* in the balance sheet. Figure 13-14 shows the formula for calculating ROCE. Refer to Figure 13-12 to work out the operating profit number.

$$\text{ROCE} = \frac{\text{Operating profit}}{\text{Fixed assets} + \text{Working capital}} \times 100$$

Figure 13-14: Calculating return on capital employed.

If you think about it, return on capital employed is the same as the return on the shareholders' funds plus the long-term loans, or the 'financed by' bit of the balance sheet.

Current ratio

You calculate the current ratio by dividing your current assets by your current liabilities. Only one rule exists about how high (or low) the current ratio should be. It should be as close to 1:1 as the safe conduct of the business allows. This isn't the same for every type of business.

A shop buying in finished goods on credit and selling them for cash can run safely at 1.3:1. A manufacturer, with raw material to store and customers to finance, may need over 2:1. This is because the period between paying cash out for raw materials and receiving cash in from customers is longer in a manufacturing business than in a retail business.

Average days' collection period

Any small business selling on credit knows just how quickly cash flow can become a problem. You calculate the average collection period ratio by dividing your debtors by the amount of credit sales, and then multiplying that by the days in the period in question. The result is expressed in days, so you can see in effect how many days it takes for your customers to pay up, on average.

Sixty days is a fairly normal period for customers to take before paying up. Forty-five days is a good target to aim for and ninety days is too long to let payment go without chasing.

This is a good control ratio, which has the great merit of being quickly translatable into a figure any businessperson can understand, showing how much giving credit costs you.

If you're selling into overseas markets, the practice on punctual payments can vary widely. Knowing your average collection period for these markets can help you to plan cash flow more effectively.

Stock control ratio

A simple way to tackle stock control is to see how many times your business turns its stock over each year. Dividing the cost of sales by the stock arrives at this ratio. The more times you can turn your stock over the better.

Gearing down

The more borrowed money a business uses, as opposed to the money the shareholders have put in (either through initial capital or by leaving profits in the business), the more highly *geared* the business is. Highly geared businesses can be vulnerable when either sales dip sharply, as in a recession, or when interest rates rocket, as in a boom. Figure 13-15 shows how to calculate gearing percentage.

Gearing levels in small firms average from 60 per cent down to 30 per cent. Many small firms are probably seriously over-geared, especially so when they're in the first stages of growth.

$$\text{Gearing percentage} = \frac{\text{Debt (long-term borrowings)}}{\text{Debt + Shareholders' funds}} \times 100$$

Figure 13-15: Calculating gearing percenta

SME.com.ph, a joint venture of the World Bank's International Finance Corporation (IFC) and Planters Development Bank, a Philippines private bank, has a range of free ratio calculator tools (go to, www.smetoolkit.org then Accounting and Finance, and then Financial Management and Reporting). Bizwiz (www.bizwiz.ca/ratios.htm) has some tools you can try before you buy; and Harvard Business School has a free tool that calculates over 20 financial ratios from your financial data (www.alumni.hbs.edu/new_alumni/toolkit/accounting.html). This tool is also a useful introduction to ratio analysis, as well as defining each ratio and the formula used to calculate it.

Keeping on the Right Side of the Law

Whether the money in the business is yours alone, provided by family and friends or supplied by outside financial institutions, you have a legal responsibility to make sure you keep your accounts in good order at all times. If you're successful and need more money to expand, you need financial information to prove your case. If things aren't going so well and you need to strengthen your position to weather a financial storm, then you have even greater need of good accounting information.

Whatever the circumstances in the background, tax and VAT authorities need to be certain that your figures are correct and timely.

Carrying out an audit

Companies with balance sheet totals in excess of £3.26 million or annual turnovers above £6.5 million are required to appoint an auditor and have their accounts audited. However, a large number of much smaller businesses still have to have their accounts audited. If, for example, you have shareholders owning more than 10 per cent of your firm, they can ask for the accounts to be audited.

You can find out the latest information on auditing small firms from your accountant or from the Business Link website at www.businesslink.gov.uk (click on Taxes, Returns and Payroll, Introduction to Business Taxes, and finally Accounting and Audit Exemptions for Small Companies).

The auditor's job is to report to the members (shareholders) of the company as to whether the accounts have been properly prepared, taking notice of the appropriate accounting rules. The auditor must also report as to whether the accounts give a *true and fair* view of the state of the company's affairs. In order to arrive at a conclusion, the auditor examines the company's records on a test basis to ensure that the accounts aren't materially incorrect. This doesn't mean that the auditor checks every detail, but he does look at a representative sample of transactions to get a feel for whether or not the books are being properly kept.

Filing your accounts

If you're trading as a company then you have to file your accounts with Companies House (www.companieshouse.gov.uk) each year.

Unless you're filing your company's first accounts, the time normally allowed for delivering accounts to Companies House is ten months from the end of the relevant accounting period for private companies. If you're filing your company's first accounts and they cover a period of more than 12 months, you must deliver them to the registrar within 22 months of the date of incorporation for private companies. Late filing will attract financial penalties details of which you can find on the Companies House website.

All companies must prepare full accounts for presentation to their shareholders, but small and medium-sized companies can send abbreviated accounts to the registrar of companies. Abbreviated accounts contain very little information that can be of use to a competitor. Nothing is given away on turnover or margins, for example, a luxury denied to larger companies. Small companies' accounts (ones with less than £6.5 million turnover, balance sheet total less than £3.26 million and fewer than 50 employees on average, to be precise) delivered to the registrar must contain:

- An abbreviated balance sheet
- Selected notes to the accounts, including accounting policies, share capital, particulars of creditors payable in more than five years and the basis of any foreign currency transactions

- A special auditor’s report (unless exempt from audit; see ‘Carrying out an audit’, earlier in this chapter)

The rules of disclosure are complex and this is only a brief outline of the requirements. If you’re unsure about the information that you have to provide, then you should take professional advice.

Managing Your Accountant

Accountancy is just another business discipline, like selling, research, administration or production. So you need to manage, motivate, reward and appraise your accountant, like any other member of staff. Whoever acts as your company accountant, be they a part-timer from outside or a fellow director, you as the owner must take the lead.

- Your monthly management accounts should be available within a week of the end of each month. You have either the wrong accountant or the wrong accounting system if you can’t achieve this standard. If you don’t yet have monthly management accounts, make that your accountant’s next measurable goal.
- Accounting systems and reports should be simple, free of jargon and supported by clear written explanations of the key issues to consider. For example, if profits are down by 10 per cent, as well as the bald figures an explanation that this was caused by a 5 per cent reduction in sales of product X and a 5 per cent increase in raw material costs gives a clear indication of responsibilities and possible remedies.

- Your accountant should also ensure that your books and records are kept to the standard required by company law. He must also see that your accounting policies meet the required standards and that accounts, VAT returns and PAYE and tax demands are dealt with in a timely manner.

Chapter 14
Managing Your Tax Position

In This Chapter

- Finding out how much tax you have to pay
- Seeing how to cut that bill, legally
- Knowing how to handle employment taxes
- Surviving a tax investigation

The government raises some £600 billion each year in one form of tax or another; that represents around 40 pence in every pound earned. Not only is the amount colossal but now about a zillion ways exist in which tax is raised. Aside from income tax, VAT (value added tax) and NI (national insurance), which most people brush across, there are taxes or reliefs from paying tax on fuel, capital gains, capital expenditure, research and development, business rates, excise duty, a climate change levy, air passenger duty, landfill tax, an aggregates levy, small company tax relief, vehicle excise duties and stamp duties, to mention but a few that the successful owner manger can expect to encounter. Each of these tax categories, in turn have a number of their own categories. VAT, for example, is levied at a standard rate, reduced rate, zero rate and exempt from VAT altogether, and the government shifts about the 50 or so product and service categories within each VAT category from time to time. The government has made 44 major changes to the tax system in the UK since 1979 and a couple of thousand minor ones.

If you think that all, or even most, of the profit you make in your business comes your way, think again. The government takes a sizeable slice of everything you make, in one way or another, and gets very nasty if you try to evade its clutches. You may be starting your first business, but government agencies have had centuries to hone their skills in extracting their pound of flesh. Since 1842, when income tax was reintroduced into Britain, everyone in business has been required to account for their income and profits.

Before you reach for your passport and head offshore, taxing entrepreneurs is a fact of life in almost every country in the world, though both the amounts and methods of assessment vary widely. Surprisingly enough, the tax climate in the UK is relatively benign and people here pay less than most. So although you may have to pay tax, you don't have to pay too much. As a Morgan Stanley advert succinctly puts it, 'You must pay taxes. But there's no law that says you gotta leave a tip.'

What follows is a guide to the taxes you should prepare to face, rather than an accurate statement of the amounts involved. In any normal year many tax rates change, and since the credit crunch the pace of those changes has accelerated sharply. VAT, for example, moved from 17.5 per cent, to 15 per cent and then back to 17.5 per cent, and is scheduled to move to 20 per cent as I write this book; and all that in the space of a year or so.

A survey of the UK tax system (www.ifs.org.uk/bns/bn09.pdf) by Stuart Adam and James Browne of the Institute for Fiscal Studies outlines the amount of tax raised by category and the changes and new taxes introduced since 1979. Not exactly bedtime reading, more a horror story.

You can keep up to date with all the taxes that apply to business in the UK on the Business Link website (www.businesslink.gov.uk; go to Taxes, Returns and Payroll).

Tackling Taxes for Different Types of Businesses

The government treats sole traders, partnerships and limited differently for tax purposes, so I look at each in turn.

Managing your tax position is one area in which timely professional advice is essential. This is even more important because tax rules can change every year. Good advice can both help to reduce your overall tax bill and increase the value of profits to the business.

Figuring out sole traders and partnerships

A partnership is treated as a collection of sole traders for tax purposes, and each partner's share of that collective liability has to be worked out. If you're a *sole trader* (in other words, self-employed) your income from every source is brought together and the profit is taxed altogether. Income from business is one of a number of headings on your general tax return form.

In the UK the key taxes that you need to calculate are:

- Income tax on profits
- Class 4 national insurance on profits
- Capital gains tax, on the disposal of *fixed assets* such as property at a profit, or when the whole business is sold
- Inheritance tax, paid on death or when certain gifts are made

Neither of the last two taxes is likely to occur on a regular basis, nor do they occur in the first few years in business, so I don't cover them here. When those taxes do come into play the sums involved are likely to be significant and you should take professional advice from the outset.

Adding up income tax

Under the self-assessment tax system in the UK, you pay taxes for your accounting year in the calendar year in which that accounting year ends. Special rules apply for the first year and the last year of trading to ensure tax is charged fairly.

If your turnover is low – currently in the UK less than £15,000 per year – you can summarise your income on three lines: sales, expenses and profit. If your turnover is above the minimum, you have to summarise your accounts to show turnover, gross profit and expenses by account categories, such as vehicle running costs, advertising, telephone and rent.

No matter how you account for your business income, as a sole trader or partnership you get to deduct a personal allowance amount from your profit figure, paying income tax on your profit minus your personal allowance. The personal allowance is the current threshold below which you don't pay tax.

Calculating class 4

You calculate class 4 national insurance based on taxable profits. The percentage you pay depends on what range your profits fall in. Expect to pay around 8 per cent if the number falls in a range from approximately £5,000 to £44,000. Above that figure, you pay 1 per cent. This is paid in addition to the flat-rate Class 2 national insurance contributions of about £2.40 per week.

All these rates and amounts change in March of every year, but the broad principles remain the same. You can find the latest national insurance contribution rates on HM Revenue and Customs' website (www.hmrc.gov.uk/rates/nic.htm).

Looking at levies on companies

Companies have a legal identity separate from those who work in them, whether or not those workers also own the company. Everyone working in the business is taxed as an employee. The company is responsible through the pay as you earn (PAYE) system for collecting tax and passing it to the tax authorities.

Directors' salaries are a business expense, just as with any other wages, and are deducted from the company's revenues in arriving at its taxable profits.

Companies in the UK pay tax in three main ways at rates that can change each year. The current company tax rates are published on HM Revenue and Customs' website (www.hmrc.gov.uk/rates/corp.htm).

- **Corporation tax** is paid on the company's profits for the year, as calculated in the tax-adjusted profits. The rate of corporation tax in the UK, and in many other countries, depends on the amount of profits made. In the UK, if the profits are less than £300,000 the small companies rate applies, currently 20 per cent. Above £1.5 million the full rate of around 28 per cent is charged. For figures in between a taper applies (all these figures are subject to annual review in the budget). Corporation tax is payable nine months after the end of the accounting period.
- **Dividend payment taxes** are levied on the distribution of profit to shareholders. This gives the appearance of taxing the same profit twice, but through a process of tax credits this double taxation doesn't generally occur. When a shareholder gets a dividend from a company it comes with a tax credit attached. This means that any shareholder who pays the basic rate of tax won't have to pay any more tax. Higher-rate tax-payers, however, do have a further amount of tax to pay.
- **Capital gains tax** is owed if a company sells an asset, say a business property, at a profit. This capital gain is taxed along the general lines of corporation tax, with lower rates applying to smaller companies.

Assessing the best legal structure

The most important rule is 'never let the tax tail wag the business dog'. Tax is just one aspect of business life. If you want to keep your business finances private, then the public filing of accounts required of companies isn't for you. However, if you want to protect your private assets from creditors if things go wrong, being a sole trader or partner is probably not the best route to take.

Company profits and losses are locked into the company, so if you have several lines of business using different trading entities you can't easily settle losses in one area against profits in another. But because sole traders are treated as one entity for all their sources of income, they have more scope for netting off gains and losses. Some points to bear in mind here are:

- If your profits are likely to be small, say below £50,000, for some time, then from a purely tax point of view you may pay less tax as a sole trader, because as an individual you get a tax-free allowance. Your first few thousand pounds of income aren't taxable. This amount varies with personal circumstances and can change in the budget each year.
- If you expect to be making higher rates of profit (above £50,000) and want to reinvest a large portion of those profits back into your business, then you may be better off forming a company. Companies don't start paying higher rates of tax until their profits are £300,000. Even then, they don't pay tax at 40 per cent. A sole trader is taxed at the 40 per cent rate by the time their profits reach about £30,000, taking allowances into account. So a company making £300,000 taxable profits can have £54,000 more to reinvest in financing future growth than does a sole trader in the same line of work.
- Non-salary benefits are more favourably treated for the sole trader. You can generally get tax relief on the business element of costs that are only partly business related, such as running a vehicle. A director of a company is taxed on the value of the vehicle's list price and isn't allowed travel to and from work as a business expense.

However, the whole area of company structure is complicated and depends heavily on what you want to achieve. For example, if you want to maximise your entitlement to make pension contributions, then a strategy that's tax efficient, for example incorporating (as turning yourself into a limited company is known), may be a bad idea. Get professional financial advice before you make any decision in this area.

Paying Taxes

The HM Revenue and Customs' website (www.hmrc.gov.uk) contains all the latest tax rates and details of almost everything you're likely to need to complete your tax returns correctly.

Valuing value-added tax

As well as paying tax on profits, every business over a certain size has, in effect, to collect taxes too. VAT (value added tax) is a tax on consumer spending. It's a European system, although most countries have significant variations in VAT rates, starting thresholds and the schemes themselves.

Essentially, you must register to collect VAT if your taxable turnover – that is, your sales (not profit) – exceeds £68,000 in any 12-month period (£70,000 if you sell by mail order or via the Internet) or looks as though it may reasonably be expected to do so. This rate is reviewed each year in the budget and changes frequently. (The UK is significantly out of line with many other countries in Europe, where VAT entry rates are much lower.)

You get no reward for collecting VAT, but you are penalised for making mistakes or for sending returns in late.

HM Revenue and Customs' website (go to www.hmrc.gov.uk, select Businesses and Corporations, and then VAT) has useful information on every aspect of the subject, including details of all VAT rates and procedures.

Registering and sending in VAT returns

VAT is a complicated tax. The general rule is that all supplies of goods and services are taxable at the standard rate (anything between 15 and 20 per cent is possible) unless the law specifically states they're to be zero rated or exempt.

In deciding whether your turnover exceeds the limit, you must include your zero-rated sales (things like most foods, books and children's clothing) because they're technically taxable; it's just that the rate of tax is 0 per cent. Leave out exempt items like the provision of health and welfare, finance and land.

HM Revenue and Customs issues three free booklets on registering for VAT – a simple introductory booklet called *Should You Be Registered for VAT?* and two more detailed booklets called *General Guide* and *Scope and Coverage*. If in doubt (and the language isn't easy to understand), ask your accountant or the local branch of HM Revenue and Customs; after all, they prefer to help you to get it right in the first place than have to sort it out later when you've made a mess of it.

Each quarter, or each year if you take that option, you have to complete a return that shows your purchases and the VAT you paid on them, and your sales and the VAT you collected on them. The VAT paid and collected are offset against each other and the balance sent to HM Revenue and Customs. If you paid more VAT in any quarter than you collected, you get a refund.

To help smaller businesses that might struggle with the more traditional VAT return, HM Revenue and Customs has introduced the Flat Rate Scheme (FRS). This enables eligible businesses to calculate their VAT payment as a percentage of their total turnover. You still have to put VAT on your sales invoices, but you don't have to do the input and output tax return to settle up your VAT. Your VAT liability is agreed as a percentage of all your sales. This percentage is allocated by HM Revenue and Customs based on the type of trade your business carries out. You can find out more about the Flat Rate scheme at www.hmrc.gov.uk/vat/start/schemes/flat-rate.htm.

From 1 April 2010 businesses have had to submit their VAT returns online and pay any VAT due electronically if either their annual turnover is over £100,000 or more (exclusive of VAT) or they should have registered for VAT on or after 1 April 2010 (regardless of turnover). If you fall into either of these two groups then you have to file all your VAT returns online (including nil and repayment returns) even if your turnover drops below £100,000 in the future.

It sometimes pays to register even if you don't have to – if you're selling mostly zero-rated items, for example, because you can reclaim VAT that you've paid out on purchases. Also, being registered for VAT may make your business look more professional to your potential customers.

Calculating VAT

You may need to extend the simple bookkeeping system I describe in Chapter 13 to accommodate VAT records. For example, the analysed cash book you use in a simple system needs additional columns to accommodate the pre-VAT sales, the amount of VAT and the total of those two figures.

Calculating the VAT element of any transaction can be confusing. Following these simple steps helps you always get it right.

1. Take the gross amount of any sum (items you sell or buy) – that is, the total including any VAT – and divide it by 117.5, if the VAT rate is 17.5 per cent. (If the rate is different, add 100 to the VAT percentage rate and divide your transaction amount including VAT by that number.)
2. Multiply the result from Step 1 by 100 to get the pre-VAT total.
3. Multiply the result from Step 1 by 17.5 to arrive at the VAT element of the bill.

Completing the VAT return

This has to be where a computer-based bookkeeping system wins hands down. The accounting package automatically generates VAT returns. All you have to do is enter the current VAT rate. If you take web-enabled software updates you may not even have to do this.

Basically, VAT inspectors are interested in three figures:

- The amount of VAT you collected on the goods and services you sold.
- The amount of VAT collected from you by those who've sold you goods and services.
- The difference between those two sums. If the difference is positive, that's the amount of VAT due to be paid. If the number is negative, you're entitled to reclaim that amount.

For a business VAT is a zero-sum game – you don't make money and you don't pay money – the end consumer picks up the tab.

The final two numbers are a check on the reasonableness of the whole sum. You have to show the value of your sales and purchases, minus VAT, for the period in question.

The person registered for VAT has to sign the VAT return. Remember that a named person is responsible for VAT, a limited company being treated as a person in this instance. Not only are you acting as an unpaid tax collector, but also you face penalties for filing your return late or incorrectly. You have to keep your VAT records for six years and periodically you can expect a visit from a VAT inspector.

Choosing cash or income accounting

Generally, VAT is levied on invoiced sales, so in theory and often in practice occasions can arise when you have to pay VAT on sums you haven't collected yourself. This unhappy state of affairs can happen if you send out an invoice at the end of the quarter and your customer hasn't paid by the time you have to make the VAT return. If this proves a major problem you can usually elect to pay VAT on a cash basis, rather than the strictly more correct income recognition basis that's triggered when you send out your invoices.

Minimising taxes

You have no reason to arrange your financial affairs in such a way that you pay the most tax! While staying within the law by a safe margin, you can explore ways to *avoid* as opposed to *evade* tax liabilities. This is a complex area and one subject to frequent change. The tax authorities try most years to close loopholes in the tax system, while highly paid tax accountants and lawyers try even harder to find new ways around the rules.

Some of the areas to keep in mind when assessing your tax liability are:

- Make sure to include all allowable business expenses. Especially when you've recently set up in business, you may not be fully aware of all the expenses that you can claim.
- If you've made losses in any tax period, under certain circumstances you may carry these forward to offset future taxable profits or backward against past profits.
- You can defer paying capital gains tax if you plan to buy another asset with the proceeds. This is known as *rollover relief* and you can use it normally up to three years after the taxable event. Check out this website for the latest position on this and other capital gains tax reliefs: www.hmrc.gov.uk/cgt/businesses/reliefs.htm.
- Pension contributions reduce your taxable profits. You may even be able to set up a pension scheme that allows you some say over how those funds are used. For example, your pension fund can be used to finance your business premises. The pension fund in effect becomes your landlord. The company then pays rent, an allowable business expense, into your pension fund, which grows tax free.
- If you do intend to buy capital assets for your business, bring forward your spending plans to maximise the use of the *writing-down allowance*, which is the portion of the cost of the asset you can set against tax in any year. For example, if you propose to buy a computer you may be

allowed to charge 100 per cent of the cost in the year you make the purchase. For a car, the proportion is just 25 per cent (up to a maximum vehicle cost of £12,000). If, for example, you know in March that you intend to buy a new computer later that year, by making the purchase before 5 April you can take the writing-down allowance in that tax year. If you delay until after that date you have to wait until the following tax year to get the benefit of a lower tax bill.

- Identify non-cash benefits that you and others working for you can take instead of taxable salary. For example, a share option scheme may achieve the same, or better, level of reward, with less tax payable.
- Examine the pros and cons of taking your money out of a limited company by way of dividends or salary. These routes are taxed differently and may provide scope for tax reduction.
- If your spouse has no other income from employment, she can earn a sum equivalent to her annual tax-free allowance (currently about £6,000) by working for your business. HM Revenue & Customs is currently looking hard at the taxation of husband and wife partnerships and companies, so check with your accountant to confirm what is allowed. The HM Revenue and Customs' website (www.hmrc.gov.uk/manuals/bimmanual/BIM72065.htm) gives you their take on the subject.
- If you incurred any pre-trading expenses at any stage over the seven years before you started up in business, you can probably treat them as if you incurred them after trading started. Such expenses can include market research, designing and testing your product or service, or capital items such as a computer bought before you

started trading and then brought into the assets of your business.

- You may be able to treat the full purchase price of business assets you bought through hire purchase in your capital allowances calculation.

This list is indicative rather than comprehensive. Taxation is a field in which timely professional advice can produce substantial benefits in the form of lower tax bills.

Handling Employment Taxes

Not only must you pay tax on your business profits and collect value-added tax from suppliers for onward transmission to an ever-hungry exchequer, but you also have to look after your employees' tax affairs too. As an employer you have a legal responsibility to ensure that an employee's taxes are paid and you can end up picking up the tab yourself, if the employee fails to. So ensure that you collect tax from employees' pay before paying them.

Paying PAYE

Income tax is collected from employees through the pay as you earn (PAYE) system. The employee's liability to income tax is collected as it's earned instead of by tax assessment at a later date. If the business is run as a limited company, then the directors of the company are employees. PAYE must be operated on all salaries and bonuses paid to directors, yourself included.

HM Revenue and Customs now issues booklets in reasonably plain English about how PAYE works. The main documents you need to operate PAYE are:

- A deduction working sheet (Form P11) for each employee
- The PAYE Tables – two books of tax tables are in general use, which are updated in line with the prevailing tax rates
  - Table A Pay Adjustment Table shows the amount that an employee can earn in any particular week or month before paying tax
  - Tables B to D and LR Taxable Pay Tables show the tax due on an employee's taxable pay
- Form P45, which is given to an employee when transferring from one employer to another
- Form P46, which is used when a new employee doesn't have a P45 from a previous employer (such as a student starting work for the first time)
- Form P60, which is used so that the employer can certify an employee's pay at the end of the income tax year in April
- Form P35, the year-end declaration and certificate for each employee – this is used to summarise all the tax and national insurance deductions from employees for the tax year
- Form P6, the tax codes advice notice issued by the Inspector of Taxes telling you which tax code number to use for each employee

You work out the tax deduction for each employee using the following steps. (For *week* read *month*, if that is the payment interval you use.)

1. Add the current week's gross pay to the previous total of gross pay to date, to show the total gross pay up to and including this week of the tax year.

2. Check the tax code number of the employee on Table A, to arrive at the figure of tax-free pay for that particular week.

3. Deduct the amount of tax-free pay from the total pay to date, to get the amount of taxable pay.

4. Work out the tax due on the total taxable pay for the year to date using Table B. Then make the appropriate deduction to allow for the tax due.

5. Deduct the amount of tax already accounted for in previous weeks from the total tax due, to work out the tax due for the week.

Allocating national insurance

As well as deducting income tax, as an employer you must also deduct national insurance (NI) contributions. Three rates of contributions apply for NI purposes:

- Table A – the most common rate, used in all cases except for those who qualify for Table B or C
- Table B – used for certain married women who have a certificate for payment at a reduced rate
- Table C – used for employees who are over pension age

For Tables A and B you need to calculate two amounts: the employee's contribution and the employer's contribution. For Table C no employee's contribution is payable. The amounts of contributions are recorded on the same deduction working sheets that you use for income tax purposes.

You can find the amounts of NI due by referring to the appropriate table. The tables show both the employee's liability and also the total liability including the employer's contribution for the week or month. You must record both these figures on the deduction working sheet.

Accounting for employment taxes

When you pay out wages and salaries to your staff, you need to record the net pay in your cash book as well as the PAYE and NI you have paid to the Collector of Taxes.

If you have only one or two employees then the record of the payments in the cash book, together with the other PAYE documentation, is probably sufficient. But if you have any more you should keep a wages book.

The deductions working sheet gives you a record of the payments made to each employee throughout the year. You also need a summary of the payments made to all employees on one particular date.

The law requires that employers *must* provide their staff with itemised pay statements, known as payslips. These must show:

- Gross pay
- Net pay
- Any deductions (stating the amounts of each item and the reason the deductions are made)

As an employer you have a legal obligation to operate PAYE on the payments you make to your employees if their earnings reach the national insurance lower earnings limit

(LEL). Currently, this is around £100 a week and up to a maximum of circa £5,000.

HM Revenue and Customs' website has details on the basics of employment taxes and related matters (www.hmrc.gov.uk/paye/intro/basics.htm).

Tax Cafe (www.taxcafe.co.uk) publishes a range of regularly updated tax advice guides aimed at anyone wanting to find out how to pay less tax legally. It also offers an online tax advice service, where you can ask experts complex business tax questions, including those on VAT. Responses in three to five working days cost £89.95. The Express service, where questions asked before 12 noon on a working day are answered the same day, costs £129.95. Anyone using either of these services also receives a complimentary electronic copy of their comprehensive tax guide *How to Save Tax*, worth £19.95.

Part IV

Making the Business Grow

'If you want to be part of our management team, you've got to be able to do this.'

In this part . . .

Growing your business is the biggest and most rewarding challenge of all – if you can get it right. Running a bigger business takes no more hours a day than running a small one, but it can be a whole lot more profitable. Once you get your business online many of the processes that create growth, selling 24/7, dealing with routine queries or taking in applications from prospective employees, can be automated.

A growing business usually means taking on more people, and more people means a change in your role. The best way to move forward is to get others to do what you want them to do, because they want to do it. The trick in accomplishing that small miracle involves building teams and delegating tasks for them to carry out, with your key task to become an effective leader and motivator.

Chapter 15

Doing Business Online

In This Chapter

- Understanding the power of the Internet and how to use it
- Checking out how you can add value to your business online
- Getting help with your website
- Making sure you get seen online
- Tracking traffic

Sure no one has yet sold a battleship online, though I guess if it was possible the government would have at least one aircraft carrier to put on its website. Hard to see how it would fit into a "shopping basket". Nevertheless according to AM Online (www.am-online.com/NewCarSalesFigures), an automotive media publication, in August 2010 some 55, 305 new motor vehicles were sold online, including 25 Bentleys, 275 Jaguars and 125 Porches. According to the Office for National Statistics (www.statistics.gov.uk/pdfdir/rs1010.pdf) the average weekly value of Internet retail sales in the UK in September 2010 was £481 million, which equated to approximately 8.8 per cent of total retail sales.

A report commissioned by Google, published in October 2010 indicated that Britons spend a higher proportion of their money online than any other country in the Organisation of Economic Co-operation and Development (OECD), another name for the world's richest countries.

Appreciating the Power of the Internet

So just how big is the Internet? Well, in September 2010, when I was writing this edition, over 2 billion people, more than a quarter of the world's population, were online and using methods of connectivity infinitely superior to the early primitive telephone links. That growth has itself been overtaken by the volume of traffic driven over the Internet itself. According to industry estimates some 150 exabytes (billion gigabytes) of data washed through the Internet in 2005. By 2010 that had risen to 1,200 exabytes, a growth of 700 per cent.

Richness versus reach

The Internet has largely changed the maths of the traditional trade-off between the economics of delivering individually tailored products and services to satisfy targeted customers ('Richness') and the requirement of businesses to achieve economies of scale ('Reach'). Figure 15-1 shows how as the richness grows, so too does the number of potential customers. The internet is the perfect medium to enable richness and reach to extend The near-impossible-to-find second-hand book that you had to track down laboriously and at some cost is now just a mouse click away. The cost of keeping a retail operation open all hours is untenable but sales can continue online all the time. Once a small business couldn't have considered going global until many years into its life. But thanks to the Internet, today the business can sell its wares to anyone, anywhere, with a basic website costing a few hundred pounds and with little more tailoring than the translation of a few dozen key words or phrases and a currency widget that handles its payments. Internet has made real what in the 1970s Marshall McLuhan, a

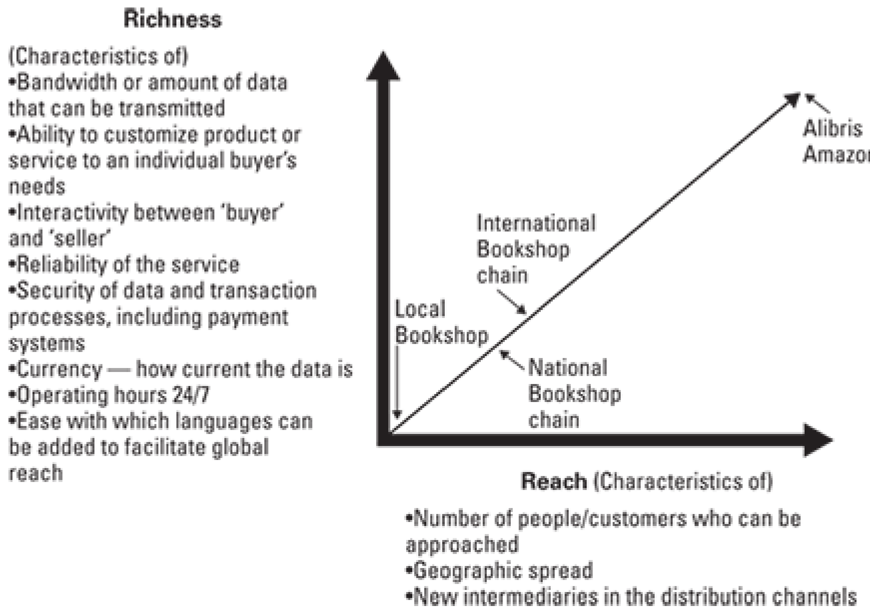
Canadian visionary of marketing communications, called the 'Global Village'.

The book business is a powerful illustration of the way a product and its distribution systems endure in principle while changing in method over the centuries. From 1403 when the earliest known book was printed in Korea, through to Gutenberg's 42-line Bible printed in 1450, which in turn laid the foundations for the mass book market, the product, at least from a reader's perspective, has had many similarities. Even the latest developments of in-store print-on-demand and ebook delivery such as that by Amazon's Kindle look like leaving the reader holding much the same product. What has, however, transformed the book business is its routes to market, the scope of its reach and the new range of business partnerships and affiliate relationships opened up by the Internet. The Alibris case is a powerful example of how the Internet has affected the way in which marketing strategy is developed and implemented – refer to the nearby sidebar 'Alibris – selling the old in a very new way'.

Clicks and bricks

Of course the Internet business world and the 'real' world overlap and, in some cases, overtake. Woolworths, for example, died on the UK high street in 2009 only to be born again on the Internet. Many of the old economy entrants to the e-economy have kept the 'mortar' as well as acquiring 'clicks'. Trust stems from customers being able to physically see what the company stands for. Tesco, a UK-based international retailer, uses specially developed software to offer an intelligent Internet tool that reacts to customers' shopping habits, suggesting different sites related to subjects or products they're interested in. In that way Tesco hopes to build a similar level of trust to that achieved in its stores, but over the Internet. The firm uses its local stores for ‘pick and pack’ and delivers locally using smaller vehicles.

Figure 15-1: Richness versus reach in the book business.



Not in the High Street

When Holly Tucker and Sophie Cornish launched their online retail venture four years ago they knew they were innovators. Their business, Not in the High Street, puts hundreds of personalised and unique gifts – gold rings, linen shawls, organic scented candles, overnight bags and more – all on the one website. Rather than trudging round dozens of shops or scouring the Internet, the pair has brought a near inexhaustible choice of gifts under the umbrella of a single online shopping mall. In fact, the collections of gifts they offer are unlikely to feature on many high streets, now almost exclusively the domain of big multiples with standardised product ranges. The flood of charity shops that fill up vacant slots left by the growing band of failed retailers are unlikely to appeal to the discerning gift buyer either.

It’s hardly surprising then that the business hit £6.4 million turnover in year two and in 2010 reached £14 million. That was also the year the business made its first profit, giving the founders some modest return on their £70,000 initial investment, raised by mortgaging their homes. The rest of the funds, some £7.5 million, came from venture capital firm Index Ventures, which has a track record of success in the sector having previously backed Betfair, Net-a-Porter,and Last.fm. Ben Holmes, a partner at the venture capital firm, recognised that Tucker and Cornish were onto something with their idea of putting 35,000 products sourced from small businesses around the country on a single website, available to drop into one online shopping basket. Most of Not in the High Street’s 3,200 suppliers either have no online presence themselves or are too small to have much visibility in a crowded Internet marketplace.

The pair see the world through very different spectacles to Accenture, the management consultants. In their recent study of tomorrow’s consumers, Accenture concluded: ‘Stores as we know them will no longer be relevant. Many shoppers will not even visit one.’ Not in the High Street plans to open temporary shops in the real high street over each Christmas period, with the aim of bringing the web experience to life. Most retailers go from bricks to clicks, but doing things in unusual ways is what entrepreneurs excel at.

Recognising the limits – there are none!

Even if you think that e-business offers you few advantages you could find yourself facing a range of unexpected threats and competitors heading your way courtesy of the Internet. For example, the competitors that a new offline business currently faces are probably small and perhaps even big firms in its own country or area and large international firms from elsewhere in the world. But with the Internet the new business could now have small firms similar to itself, but based anywhere in the world, entering its market. Potentially, this could put the business starter up against hundreds if not thousands of competitors, all with the advantages of nimbleness and being driven by hungry entrepreneurs just like the business starter – you too, of course.

Your businesses face dangers as a consequence of the Internet by virtue of its near unlimited capacity for penetrating and opening up markets to new entrants and innovations. Not only can competitors of all sizes from around the world attack your market using the Internet, but if you don't have an Internet presence then your company may also:

- Appear old fashioned and out of date compared with other firms that do have websites.
- Miss out on some business that may only go to firms with an Internet presence. This is particularly true of rural markets, where the Internet has offered a degree of choice that's otherwise only available to customers in major cities.
- Lose its best staff, who leave in search of more stimulating and forward-thinking places to work.
- Miss out on the operational cost saving that can be made using e- business, which may make you uncompetitive so you lose out to other firms.

What You Can Do Online

You could be forgiven for thinking that a website is just for those who plan to sell on the Internet. That's certainly a powerful argument for getting online and perhaps the easiest one to justify financially. Using a website to sell is so important that I’ve given that topic a whole section to itself in this chapter (see ‘Selling Goods and Services’). But selling isn’t the only valuable use your business can get from being on the Internet.

Generating advertising revenue

When you have a website you have ‘readers’ who other people will pay to reach, just as they would if you had a hard copy magazine. You can sell space on your website yourself, but you should be too busy running your business to get diverted with this type of distraction. The easiest way to get advertising revenue is to get someone else to do the hard work. Google Adsense (www.google.co.uk/adsense), for example, matches advertisements to your site’s content and you earn money every time someone clicks an ad on your site.

You can check out the dozens of other affiliate advertising schemes at Internet Ad Sales (www.internetadsales.com), a site that reviews all online advertising products and trends.

Recruiting staff

When you start to grow your business you can advertise for staff on your own website. In that way you can be sure applicants know something of your business and you could cut out most of the costs of recruitment.

Nearly a quarter of all jobs are filled using *job boards*, websites where employees and employers can get together much along the lines of a dating agency. The Internet’s advantages are speed, cost and reach. You can get your job offer in front of thousands of candidates in seconds. The fees are usually modest, often less than regional paper job adverts. Services through job boards range from passive were employers and employees just find each other, to the proactive where the website searches online candidate databases and makes suitable candidates aware of your vacancy. Useful sites include:

- **Futurestep** (www.futurestep.com): Covers all job functions and industry sectors.
- **Monster** (www.monster.co.uk): Attracts approximately 100,000 visits per month and contains over a million curricula vitae. Its vacancies cover every industry sector and regional area.
- **Webrecrui**t (www.webrecruit.co.uk): Though the fee is a relatively high £595, they'll reimburse you if they can't fill your job.
- **Whatjobsite.com** (www.whatjobsite.com): Has a search facility that lets you look narrow down the job boards by country and region to see those most suited to the job on offer and the industry you're in.

Answering frequent questions

Businesses get dozens of phone calls and letters asking essentially the same questions. By having an Frequently Asked Questions (FAQ) section on your website you can head off most of those enquiries and save time and money.

Vebtools (http://vebtools.com/faqs-generator) have a free FAQ generator. Just enter the questions you receive frequently and their respective answers, click the generate button and the script outputs a complete FAQ page for you.

Carrying out research

The Internet is a rich source of market data, much of it free and immediately available. But you can't always be certain that the information is reliable or free of bias because it can be difficult if not impossible to always work out who exactly is providing the information. That being said, you can get some valuable pointers as to whether or not what you plan to sell has a market, how big that market is and who else trades in that space. The following sources should be your starting point:

- **Google Trends** (www.google.co.uk/trends) provides a snapshot on what the world is most interested in at any one moment. For example, if you're thinking of starting a bookkeeping service, entering that into the search pane produces a snazzy graph showing how interest measured by the number of searches is growing (or contracting) since January 2004 when Google started collecting the data. You can also see that South Africa has the greatest interest and the Netherlands the lowest. You can tweak the graph to show seasonality thus showing that Croydon registers the greatest interest in the UK overall and 'demand' peaks in September and bottoms out in November.
- **Google News** (http://news.google.co.uk) contains links to any newspaper article anywhere in the world covering a particular topic over the last decade or so listed by year. Asking for information on baby clothes, for example, reveals recent articles on how much the average family spends on baby clothes, the launch of a thrift store specialising in second-hand baby clothes and the launch of an organic baby clothes catalogue.
- **Microsoft** (http://adlab.microsoft.com/Demographics-Prediction) is testing a product that can give you masses

of data on market demographics (age, sex, income), purchase intentions and a search funnel tool that helps you understand how your market searches the Internet. Using the demographics tool you can find that 76 per cent of people showing an interest in baby clothes are female and, surprisingly, 24 per cent are male. The peak age group is the 25- to 34-year-olds and the lowest is the under 18s, followed by the over 50s.

- **Blogs** are sites where people, informed and ignorant, converse about a particular topic. The information on blogs is more straw in the wind that fact. Globe of Blogs (www.globeofblogs.com), launched in 2002, claims to be the first comprehensive world weblog directory. It links up to some 70,000 blogs, searchable by country, topic and about any other criteria you care to name. Google (http://blogsearch.google.com) is also a search engine to the world's blogs.
- **Trade Association Forum** (www.taforum.org; go to Directories and then Association Directory) is the directory of trade associations on whose websites are links to industry-relevant online research sources. For example, you find the Baby Products Association listed, at whose website you can find details of the 238 companies operating in the sector with their contact details.
- **The Internet Public Library** (www.ipl.org) is run by a consortium of American universities whose aim is to help Internet users with finding information online. The website has extensive sections on business, computers, education, leisure and health.
- **FindArticles.com** (www.findarticles.com) aims to provide credible, freely available information that you can trust. It has over 10 million articles from thousands

of resources, archived dating back to 1984, on its website. You can see a summary of all articles and most are free, though in some cases you may need a modest subscription rarely costing more than a few pounds.

By running surveys online (see Chapter 4 for more on constructing surveys) you can find out more about your customers' needs, check out whether new products or services would appeal to them and monitor complaints, so preventing them becoming problems. Zoomerang (www.zoomerang.com) and Instant Survey (www.instantsurvey.com) are among a host of companies providing free or nearly free online survey tools.

Establishing an Internet Presence

Thousands of small companies seduced into having a presence on the web quickly become disappointed. Part of the reason is that in the rush to put together a website they end up with little more than an online leaflet or brochure. *E-commerce*, which is where the real value from being on the Internet arises, only comes about when you can buy and sell products and services, just as you can with any other route to market, and equally importantly when you can open up a dialogue with customers. That conversation can be as simple as a strong FAQ section, a blog or an invitation to ask for specific information.

It's worth persevering because the gain is almost always worth the pain. Some of the other benefits for a small business of being on the Internet include:

- You can have global reach from day one, without the bother of getting a passport, a visa or turning up at an airport.

- You can extend your working time to 365 days a year, 24 hours a day, without creating an enormous wages bill or imposing impossible demands on the few people you have who can deal with sales enquiries or handle customer support.
- Things can change very quickly in a small business. If you do business online you can make changes to your product and service offers or prices quickly and inexpensively and fine-tune your propositions.
- You can reduce human error by eliminating some stages in each transaction. The more times a piece of information is handled between a customer's enquiry and the order being fulfilled, the greater the chances are of something going wrong.

Read Ben Carter, Gregory Brooks, Frank Catalano and Bud Smith's *Digital Marketing For Dummies* (published by Wiley) to get a thorough insight into this vital aspect of marketing.

Promote your website by acquiring links on other commercial websites, using key words to ensure you can be found, and by promoting outside the Internet – feature your website address on all products and publications. Fill your homepage with regularly updated success stories, give discounts to first-time buyers and ask customers to bookmark your site or add it to their list of favourites on their browser. You could also try partnering with manufacturers and distributors in related business fields.

Deciding on content

The danger with producing content for websites is to fall into the trap of believing that because it costs virtually nothing to load your site up with copy, pictures, diagrams and videos, it's a good idea to do so. As I explain in Chapter 10, when it comes to marketing messages, less is best. Think through what you want website visitors to do as a result of arriving at your site – place an order, ask a question, gather more information, see a demonstration and so forth; and then produce the minimum clear content to achieve those goals.

Designing the website

You probably already have a basic website writing tool with your office software. If you use Microsoft Office you'll find free web design tools in the Publisher section of your software. Basic stuff, but it gets you up and running. For more on building a website for free, check out David Crowder's excellent *Building a Web Site For Dummies* (published by Wiley).

You can also find hundreds of packages from £50 to around £500 that, with varying amounts of support, help you create your own website. Take a look at these sites:

- **BT Broadband Office** (www.btbroadbandoffice.com/businesstoday/0,9737,cats-5528530,00.html) has dozens of articles on how to improve your website design.
- **Top Ten Reviews** (http://website-template-service-review.toptenreviews.com) provides an annual report on the best website creation templates rated by ease of use, help and support, value for money and a score of other factors. The best buy as I write this edition is a third of the price of the third ranking programme.

- **Web Wiz Guide** (www.webwiz.co.uk/kb/website_design) has a tutorial covering the basics of web page design and layout.

More expensive options come with access to an editor, hours of webmaster assistance per month, a domain name, hosting, email and more.

Good website design is essential to having a successful experience online. Even though broadband is fast becoming the norm, you should pay careful attention to *loading time* – that is, how long it takes the recipient's computer to download your data. If loading takes too long, people may leave without looking at your site at all and you may have lost an opportunity for a sale. The rules here are to use graphics rather than photographs, which take up too much memory, and keep the text short, sweet, legible and attractive. You can check your website's loading time at the search engine optimisation company 1-Hit's website: www.1-hit.com/all-in-one/tool.loading-time-checker.htm (I explain search engine optimisation in the later section 'Gaining Visibility').

REMEMBER

Research shows that visitors have to be hooked within three clicks or they jump ship to a more user-friendly website. So clear signposting is essential, with a simple menu of options on every page and a link back to your homepage so visitors can get back to their starting point.

Information on your site needs to be fresh and informative. Nothing is quite so off-putting as being on the fastest method of global communication known to humanity and seeing an invitation to a seminar that's already taken place or a special offer that expired weeks ago. You can buy in a news feed covering topics related to your business such as finance, travel or politics, or just general news, to ensure that your front page is always busy and topical, without you having to do a single thing. Check out sites such as Yellowbrix (www.yellowbrix.com) that harvest hundreds of thousands of news articles every day from the most respected news sources and categorise them into topics covering virtually every industry.

Here are some website design do's and don'ts:

- **Do think about design.** Create a consistent visual theme grouping elements together so that your reader can easily follow the information you're presenting.
- **Do prepare your content carefully.** Focus on the needs of your target audience and make the content credible, original, current and varied.
- **Do plan your site navigation.** Your pages need to be organised intuitively so they're easy to navigate.
- **Do consider usability and accessibility.** Use graphics sparingly because not everyone has super access speeds. Optimise your hypertext mark-up language (HTML), especially on your home page, to minimise file size and download time by removing excess spaces, comments, tags and commentary.
- **Do optimise for searching.** Build in key words and tags and markers so search engines easily find your site (see the later section 'Gaining Visibility').
- **Don't have long pages.** Readers typically ignore content beyond the first one-and-a-half to two page lengths.
- **Don't have pointless animation**. Many are distracting, poorly designed in terms of colour and fonts, and add unnecessarily to file size, slowing down your reader's search.

- **Don't use the wrong colours.** Colour choice is crucial; black text on a white background is the easiest to read and other colours, such as reds and greens, are harder to read. Check out Visibone's website (www.visibone.com/colorblind) for a simulation of the web designer's colour palette of browser-safe colours.
- **Don't waste your reader's time.** Making readers register on your site may be useful to you, but unless you have some compelling value to offer don't. If you absolutely must, keep registration details to a couple of lines of information.

Check out Bad Website Ideas (www.badwebsiteideas.com) to see how to avoid the biggest howlers, and in consequence how to get your website design right.

Using a consultant

Thousands of consultants exist who claim to be able to create a website for you. Prices start from £499 where a consultant tweaks an off-the-peg website package slightly to meet your needs, to around £5,000 to get something closer to tailor-made for you. The Directory of Design Consultants (www.designdirectory.co.uk/web.htm) and Web Design Directory (www.web-design-directory-uk.co.uk) list hundreds of consultants, some one-man or one-woman bands, others somewhat larger. You can look at consultants' websites to see whether you like what they do. Web Design Directory also has some useful pointers on choosing a designer.

If you're working within a set budget you could consider auctioning off your web design project. Make sure though that those who you offer the auction to are going to do the job that you need.Using People Per Hour (www.peopleperhour.com) you state how much you're prepared to pay with a description of the project and freelancers around the world bid under your price, with the lowest bidder winning.

Registering domains

Having an Internet presence means you need a *domain name* – the name by which your business is known on the Internet and that lets people find you by entering your name into their browser address box, such as `example.com`. Ideally, you want a domain name that captures the essence of your business neatly so that you'll come up readily on search engines and one that's as close as possible to your business name (see Chapter 5 where I cover business names).

Domain names come in all shapes and sizes. Those such as '.com', exude an international / US flavour, whilst '.co.uk' implies a UK orientation. Charities usually opt for '.org', or '.org.uk' whilst '.net' or '.net.uk' are used by Network Service Providers. Businesses often use '.biz' but it doesn't really matter what domain you use, what you want is to be seen.

Some domains are restricted. For example '.ac.uk' is used by higher education institutes in the UK and '.gov.uk' is used by UK government departments.

If your business name is registered as a trademark (see Chapter 5) you may (as current case law develops) be able to prevent another business from using it as a domain name on the Internet.

After you've decided on a selection of domain names your Internet service provider (ISP), the organisation that you use to link your computer to the Internet, can submit a domain name application on your behalf. Alternatively, you can:

- **Use Nominet UK** (www.nic.uk), the Registry for British Internet domain names, where you find a list of members who can help you register, though you can do so yourself if you're web aware.
- **Use a world directory of Internet domain registries** if you want to operate internationally, for example by using a `.com` suffix or a country specific domain. Check out www.internic.net and www.norid.no/domenenavnbaser/domreg.html.
- **Use a company that sells domain names,** such as Own This Domain (www.ownthisdomain.co.uk) and 123 Domain Names (www.123domainnames.co.uk), which provide an online domain-name registration service usually with a search facility so you can see whether your selected name has already been registered. Companies such as Altaire (www.altaire.com/domain_names) and Electric Names (www.electricnames.co.uk) have detailed domain name registration on their websites as well as offering a same-day registration service for prices between £10 and £25 per annum.
- Obtain free domain names along with free web space by registering with an Internet community. These organisations offer you web pages within their community space as well as a free domain name, but most communities only offer free domain names that have their own community domain tagged on the end – this can make your domain name rather long and hard to remember.

The IT and E-commerce section of the Business Link website (www.businesslink.gov.uk) has comprehensive up-to-date information on all aspects of getting your website up and running as well as complying with the latest regulations.

Selling Goods and Services

Everything from books and DVDs, through computers, medicines and financial services and on to vehicles and real estate are sold or have a major part in the selling process transacted online. Holidays, airline tickets, software, training and even university degrees are bundled in with the mass of conventional retailers such as Tesco that fight for a share of the ever-growing online market. The online gaming market alone has over 217 million users.

The value of web transactions in the US in 2009–2010 was over £315billion and in the UK alone was £81 billion, up from £19 billion in 2002. The value of sales to households as opposed to businesses over the same period doubled to £20 billion and £78 in every £100 spent on the Internet was used to buy physical goods. In the US 16 million people visited jewellery websites, 35 million hit flower and gift sites and 42 million looked for travel related products and services.

Not all business sectors are penetrated to the same extent by the Internet. According to Forrester (www.forrester.com), the Internet research company, although sales of clothing and footwear online is a multi-billion-pound business it only accounts for 8 per cent of total sales. Contrast that with computers where 41 per cent of sales occur online.

Using third party websites

Selling online may be a sound way into market, but you still have another option: tag along with someone else, much as you would if you were selling a product into a shop. That way you don't have to deal with the procedures of selling on the Internet that, aside from having your own website, require systems for showing and describing the goods and services on offer, as well as ordering payment and fulfilment facilities (these topics are the subject of the following sections).

WARNING! The main advantages to setting up your own selling procedures are that you have greater control over where your products appear, which can be important to people passionate about their venture; and you get to keep the whole profit margin rather than sharing it with others in the channels of distribution. But in varying ways you could end up passing up to a quarter of your margin in this way. Setting up your own online sales operation requires several thousand pounds of investment up front and a continuing stream of investment to keep your systems up to date, much as a retailer would need new shop fittings.

The other way of getting your goods and services to Internet markets is to piggyback on established, ready-built e-tail platforms such as:

- **Amazon** (www.amazon.co.uk/gp/seller/sell-your-stuff.html) will list, take payment, insure and, if required, pick, pack and deliver your products through its distribution system. Amazon provides tools to make it easy for you to upload inventory onto the website and you can have an unlimited number of listings to sell to its millions of customers. No fixed term contract exists and charges depend on the type of products sold.

- **eBay** (http://pages.ebay.co.uk/businesscentre) isn't just a place to pick up a bargain and sell on last year's ski gear when you move on to a snowboard. Sure, that's one side of the businesses. The other is the 160,000 or so people in the UK, Power Sellers as they're known, who make anything from a few hundred to tens or even hundreds of thousands of pounds. In April 2010 eBay made it even easier for sellers to become Power Sellers by reducing the minimum value of sales to £750 in order to achieve the Bronze entry standard.
- **IBidFree.com** (www.ibidfree.com) was set up by Shane McCormack, a former eBay seller, with the proposition that you can have all the features of eBay but for free. IBidFree.com was created as a perfect opportunity for the person working from home trying to market their products without all their profits being swallowed up by charges and fees. The rules are few and, unlike eBay sellers, sellers are encouraged to place a link in their auctions back to their own websites. They're also allowed to directly email each other to allow for better communication.

Building a store front

Okay, so you've decided to take the plunge and set up your own shop front. If you were selling from a shop you'd set out your window display and have a basket for customers to drop their shopping into prior to checking out and paying. Your online store has much the same features with buttons and boxes around your order page allowing customers to select colours, sizes and quantities, place their order, pay and track the progress of their delivery. You need to decide what you want your online store to do because with linkages to other services you can arrange payment, delivery and even stock re-ordering, all of which come at an increasing price eating into your profit margin.

You can choose between dozens of companies in the field such as Altcom (www.altcom.co.uk) and ekmpowershop (www.ekmpowershop.com), which have turnkey online shop fronts from $19.99 a month.

GoECart (www.goecart.com), now in its seventh edition, doesn't charge any listing or transaction fees and a merchant can open a store for around $3,150a year. That fee includes all you need to handle up to 20,000 products: a shop front, trolley buying system, payment acceptance, fraud protection, compete order and stock management and web traffic statistics. GoECart also claims to have the most search engine friendly architecture.

Getting paid online

If you're going to trade on the Internet then some form of online payment such as a credit card merchant account is essential. An alternative is one of a new breed of businesses tailored expressly for the Internet. The leader of the pack is PayPal (www.paypal-business.co.uk). They claim to have 100 million accounts around the world and firms using their services get an average of 14 per cent uplift in sales.

Using PayPal you can in effect get a merchant account with all major credit and debit cards in one bundle without set up fees or a lengthy application process and start accepting payments within minutes. PayPal isn't free; you pay 20p per transaction and a sliding charge ranging from 3.4 per cent if your transactions amount to £1,500 in any month down to 1.4 per cent if sales are above £50,000 a month.

PayPal's Micropayments provides special rates for your low value transactions. For example, products selling for £2 incur a cost of 15p to receive payment.

eBay's international payments incur additional costs. PayPal charges a standard cross-border fee of 1 per cent and a foreign currency conversion fee of 2.5 per cent.

RBS WorldPay (www.rbsworldpay.com), Click and Buy (www.clickandbuy.com) and Durango (www.durangomerchantservices.com) offer similar services.

You can keep up with all the various services by reading the Merchant Account Forum (www.merchantaccountforum.com), a free newsletter set up by Richard Adams who was so frustrated in his efforts to set up a merchant account for his first online business he decided to set up a site to review merchant accounts.

Fulfilling orders

You have two main options when it comes to actually getting products and services to customers after they've bought online. The simplest way is doing it yourself. Take the orders, clear the payment and despatch the product.

MetaPack (www.metapack.com), automates and improves customer delivery using one or more of 23 carriers that provide between them some 590 services. You detail what you're sending, to whom, when you want it delivered and any other particulars such as security and the MetaPack software recommends a solution and can do anything from printing off a despatch label to booking a courier pick-up. If you don't want the hassle of managing your own fulfilment you can ship your products to an outsourced fulfilment business that handles as much or as little of the process as you want. Contact companies such as International Logistics (www.ilgroup.biz) or you can search the UK Warehousing Association's membership database (www.ukwa.org.uk), where you can look for a company in your area by specific tasks such as garment hanging, order picking, shrink wrapping and cold storage.

Amazon (https://services.amazon.co.uk/services/fulfilment-by-amazon/features-benefits/index.html) has its own fulfilment service. When you include the cost of overhead such as warehouse costs, packing supplies, postage and labour, dealing with customer service enquiries and returns handling, letting Amazon do the job may actually be a cheaper option than doing it yourself. Amazon claims to be able to get a small electronic item through its entire system from stock held in its warehouse to cash in your bank for around £1.85.

Gaining Visibility

Unless the world that matters to you knows how to find your website, you're winking in the dark. The tricks of the trade start with ensuring that your first page (your *homepage*) is chock full of words and phrases that people put into their search pane and that Google, Yahoo! or any other search engine they're using can find. Start by brainstorming the way in which customers might start enquiring about your products or services, as well as important key words and phrases used in your industry. For example, if you're selling fire extinguishers, words such as *safety*, *protection*, *prevention* and *equipment* are probably at least as important to include in your opening text as phrases such as 'Synthetic aqueous film – forming foam agent capable of fighting class A and B fires'.

Understanding search engines

Online searching services are often grouped under the single heading of *search engines*. However two distinct services exist, directories and search engines, that both contain the key to unlock the wealth of information contained in billions of web pages throughout the Internet. Directories and search engines differ mainly in the way each compiles its database of information.

- **Directories:** These depend on people for compiling their information. You (and millions of other people from around the world) submit your website URL (your website address, for example, `www.mybusiness.com`) with a brief description of your content. Volunteer editors view the website, see whether it's appropriate for their directory and then place it in a category. Each category is further subdivided into more specific categories. For example, clicking on the category 'business' leads you to a further score of subheadings.

Dmoz (www.dmoz.org) claims to be the largest and most comprehensive human edited directory on the web, followed in size and range by WoW (www.wowdirectory.com). Web Directory List (www.webdirectorylist.co.uk)

- **Search engines:** Unlike directories no human interaction takes place with the websites submitted. Instead search engines have three major elements that attempt, with varying degrees of success, to arrive at the end result the surfer is trying to get to:
  - **The spider (also called the crawler):** The spider visits a web page, reads it and then follows links to other pages within the site. The spider is looking for HTML tags or markers that the website creator weaves in to a web page, making it more likely that the spider will find a particular page.
  - **The index:** Everything the spider finds goes into the index. Think of the index as a colossal digital book holding a copy of every web page the spider finds. This 'book' is updated every time a web page changes. Until a web page is entered into the index it's not available to those searching with a search engine. Hence the longer the interval between a site being *spidered*, as this process is known, the less likely it is that information searched for is relevant or current.
  - **Search engine software:** This is the programme that sifts through the millions of pages recorded in the index to find matches to a search. It also ranks those matches according to certain criteria to suggest which pages are most relevant. Some give a percentage score to each result suggesting which is

most likely to be the site with the information you require.

Check out Search Engine Watch (www.searchenginewatch.com) to keep abreast of major search engines and meta search engines (sites that give you results from several search engines at once), as well as the latest Nielsen NetRatings statistics for search engines and portals. The site has tips for moving up the search engine rankings and what the month's top search terms are by category.

Optimising your website*Search engine optimisation* (SEO) for short, is the best way to be sure of getting listed appropriately in a search engine.

First make a list of the words that you think a searcher is most likely to use when looking for your products or services. For example, a repair garage in Penzance could include keywords such as *car*, *repair*, *cheap*, *quick*, *reliable*, *insurance*, *crash* and *Penzance* in the homepage to pull in searchers looking for a competitive price and a quick repair. As a rule of thumb for every 300 words you need a key word or phrase to appear between 10 and 15 times. Search engines thrive on content so the more relevant content the better.

You can use products such as that provided by Good Keywords (www.goodkeywords.com), which has a free Windows software programme to help you find words and phrases relevant to your business and provides statistics on how frequently those are used. Good Keywords also has several additional filters and tools to help you refine your key word lists, but those come at a price, as you might expect. Expect to pay upwards of £63.

Search engine algorithms also like important, authoritative and prestigious terms. So although you may not be able to boast 'by Royal Appointment', if can get your press releases quoted in the *Financial Times*, your comments included in postings on popular blogs or your membership of professional institutes and associations into your homepage, your chances of being spidered rise accordingly.

Another way to gain visibility is to search out other websites with which you can swap links for free. For example, you may be able to persuade a company selling marine insurance to put a link on its site to your boat-selling website in a reciprocal arrangement. This probably only works with other small local businesses that have relatively little traffic to their websites. Still, you're not after volume but value. If another site has high-quality traffic with a strong need for your wares, this kind of arrangement may be worth the effort. Such relationships are known as *affiliate marketing*, which is new speak for a kind of finder's fee.

A variation of the affiliate marketing route is to go for banner advertising on sites that you can't get onto for free. You could even sell advertising yourself, but you need to prove a substantial volume of visitors to your site first. A number of online UK business directories exist, such as UK Business Directory (www.business-directory-uk.co.uk) and Free Index (www.freeindex.co.uk), offering free listings to UK businesses and companies in exchange for a link from your company website linking to their directory.

That, I'm afraid, is the end of the free lunch. Everything else in the visibility business costs money. You can pay to be listed on a search engine or you can 'buy' your way up the list so that you appear in the first page of any search for your business sector. The following sections consider each option.

Using a submissions service

You can build words into your website that help search engines find you, but you can also go to a professional whose job it is to move you up the rankings. Submission services such as those provided by Submit Express (www.submitexpress.co.uk), Rank4u (www.rank4u.co.uk) and Wordtracker (www.wordtracker.com) have optimisation processes that aim to move you into the all important top ten ranking in key search engines.

Payment methods vary. For example, Rank4u has a no placement, no fee deal where you pay only after it's achieved the positioning you want. 123 Ranking (www.123ranking.co.uk) has optimisation packages aimed at small and new businesses for from £299 per annum. Search Engine Guide (www.searchengineguide.com; go to Search Engine Marketing) has a guide to all aspects of search engine marketing.

Paying for placement

If you don't want to wait for search engines to find your website you can pay to have your web pages included in a search engine's directory. That won't guarantee you a position; so, for example, if your page comes up at 9,870 in Google's list then the chance of a customer slogging his way to your page is zero. The only way to be sure you appear early in the first page or two of a search is to advertise in a paid placement listing. Major search engines such as Google AdWords (http://adwords.google.co.uk), Yahoo! Search Marketing (http://searchmarketing.yahoo.com) and Microsoft adCenter (https:adcenter.Microsoft.com) invite you to bid on the terms you want to appear for, by way of a set sum per click.

Don't forget to submit the URL of your website domain name to search engines and re-register on a regular basis. Check on the search engine websites for the section headed 'Submit your site'. For example, for Yahoo! you go to http://search.yahoo.com/info/submit.html and register for free. Most search engines offer a premium registration service that involves a fee of some sort but that guarantees a better degree of exposure. Yahoo! Directory Submit (www.yahoo.com/dir/submit/intro) costs £188a year and claims to put you ahead of the herd, and their Sponsored Search service, paid for by the click, aims to get you even more visibility.

Submitting to each search engine repeatedly is time consuming but the process can be automated using some URL submission software such as that provided by WebPosition (www.webposition.com) or Web CEO (www.webceo.com) for between £95and £252 These programmes not only ensure your entry in search engines is kept up to date but also provide tips on improvement and tools to report on your search engine ranking.

If you have a compelling proposition you may persuade a search engine to offer you a 'pay-for-performance' deal, where they take a share of the profits you make from having extra visibility. One company working in this way is Highposition.net (www.highposition.net/pay-for-performance.html). *Digital Marketing For Dummies* provides an excellent primer on this complex subject.

Checking out competitors

To get some idea of what to include and exclude from your website check out your competitors' websites and those of any other small business that you rate highly. You can also get some pointers from the Web Marketing Association's Web Award (www.webaward.org). Take a look at the Winners section where you can see the best websites in each business sector. Also check out The Good Web Guide (www.thegoodwebguide.co.uk), whose site contains thousands of detailed website reviews.

You can keep track of how many times your competitors change information on their websites by using the services on offer from companies such as Update Patrol (www.updatepatrol.com) or WebSite-Watcher (www.aignes.com).

Don't get into the habit of constantly changing the fundamental layout of your website. Customers may wonder if it's still you that's running the show! Customers expect consistency as well as currency when they come to your website.

Tracking traffic

A wealth of information is available on who visits your website: where they come from in terms of geography, search engine and search term used; where they enter your website (homepage, FAQs, product specifications, price list, order page); and how long they spent in various parts of your website. That information is aside from the basic information you automatically receive from orders placed, enquiries made or email contacts.

You can use visitor data to tweak your website and content to improve the user experience and so achieve your goals for the website. For example, you may find that lots of visitors are entering your website via a link found on a search engine that takes them to an inappropriate section of your site, say the price list, when you want them to start with the benefits of your product or success stories. By changing the key words on which your website is optimised, or by putting more visible links through the site, you can drive traffic along your chosen path.

Check that your website is accessible and user friendly at all times. Many of us are impatient when it comes to web usage, and if a website doesn't work immediately, we go elsewhere!

Chapter 16

Improving Performance

In This Chapter

- Seeing why retaining customers matters
- Measuring customer satisfaction
- Discovering ways to cut costs and work smarter
- Checking out your market position
- Setting budgets
- Working smarter

An unpleasant truism in business, and in much else, is that after resources are allocated they become misallocated over time. Another way of looking at this problem is to say that just because something 'ain't broke', it doesn't mean you can't make it perform better still. To get your business to grow and keep growing needs a continuous effort to improve every aspect of that business.

In this chapter I tell you how to boost your business by keeping your customers happy, improving your efficiency and effectiveness, and increasing and expanding your business.

Checking Your Internal Systems

In order to improve performance you have to have systems in operation that help you measure performance in the first place.

The two sections following give you tips for evaluating how you spend your time and how to keep on top of your markets.

Keeping track of your routine

A good test of whether you're allocating enough time to the task of improving performance is to keep a track of how you spend your time, say, over a month. As well as recording the work you do and the time you spend on each major task, put the letter R for routine, S for strategic or I for improving performance next to the task.

A routine task is something like meeting a customer or the bank manager, delivering a product or service, or taking on a new employee. Strategic tasks include considering a major shift of activities, say from making a product to just marketing it, forming a joint venture or buying out a competitor. Improvement activities include all the elements I talk about in this chapter – activities focused on getting more mileage, lower costs or higher yields out of the existing business.

Most owner-managers spend 95 per cent of their day on routine tasks and only tackle improvement and strategic issues when they hit the buffers. For example, most entrepreneurs don't worry too much about cash until it runs out. Then they pick up the phone and press customers into paying up. What they should have done, however, is introduce new procedures for collecting cash *before* the crunch.

REMEMBER

If you're not spending at least 30 per cent of your time on improving your business and strategic issues, then you're probably heading for the buffers.

Analysing market position

A *SWOT analysis* is a way of consolidating everything you know about your competitive market position. SWOT stands for Strengths, Weaknesses, Opportunities and Threats. Many businesses use SWOT analysis regularly, and very few people try it once and never again. But for my money, SWOT is the way to go.

You can't carry out a SWOT analysis on the business as a whole. You have to analyse each important market segment separately. Because customer needs in each segment are different, you have to do different things in each segment to satisfy those needs. You may be up against different competitors in each segment, so your strengths and weaknesses are particular to that competitive environment. For example, look at travel methods – for families, car, coach and to a lesser extent train compete with each other; for businesspeople, car, plane and first-class rail travel are the biggest competitors.

Discovering strengths and weaknesses

A strength or weakness is an element that matters to the customers concerned. In fact, it has to be such an important factor in customers' minds that they don't buy without it. These are known as critical success factors and your performance against these confirms your strengths and weaknesses.

Find out the five or so things that you have to get right to succeed in your market. For retail booksellers, location, range of books, hours of operation, knowledgeable staff and ambiance may be the top five elements. Rank how well you think your competitors perform in these critical areas, or better still ask their existing, soon to be your, customers. If they score badly, you may possess a strength.

Keeping an eye on opportunities and threats

You need to recognise that an idea, invention or innovation isn't necessarily an opportunity to grow your business. An opportunity has to be attractive, durable and timely. It centres on a product or service that creates or adds value for its buyer or end user.

Working out what's attractive to you is fairly straightforward. Estimating the likely life of an opportunity or whether the time is right for its launch isn't so easy. In a way, that's the essence of an entrepreneur's skill. You're looking for opportunities that bring the maximum benefit to the business while at the same time having a high probability of success. The benefits you're looking for may vary over time. In the early years of a business cash flow may feature high on the list. Later, fast growth and high margins may be more important.

Threats can come from all directions. Changes in the political or economic climate, new legislation or hackers and computer viruses can all have an impact on your business. For example, one business founder found to his dismay that his new website linked into dozens of pornography sites – the work of professional hackers. This set his operation back months. Changes in the demographic profile of populations (more older people and fewer of working age) or changing fashions also hit all businesses.

Too many potential threats always exist for you to consider, so you need to focus on those with the greatest possible impact and that seem most likely to occur.

Doing the analysis

In the actual SWOT process you ask various groups to share their thoughts on your company’s greatest strength, its most glaring weakness, the area of greatest opportunity and the direction of the greatest threat.

To carry out a SWOT analysis, you need to consider each element separately for each major market segment.

Use the following steps to find out your SWOT quotient in each SWOT area:

1. **Determine your own view.**

   Decide what you think your business’s best feature is, what its greatest weakness is, where your opportunities to gain more customers lie and what the biggest threat facing your business is.

2. **Find out what other entrepreneurs and your management team think about these issues.**
3. **Ask your newest front-line staff the same questions.**
4. **Form a customer focus group to consider the same questions.**
5. **Analyse how far apart the views of each group are.**

   If you’re close to your customers and to your market, little difference should exist among the various groups. If a large difference exists, figure out what you can do to make sure the gap narrows and stays that way.

The question ‘So what?’ is a good one to apply to all aspects of your SWOT analysis. That helps you concentrate only on the important issues. When completed, the SWOT provides the ingredients and framework for developing your marketing strategy, which I look at in Chapter 10.

Retaining Customers

Businesses spend an awful lot of time and money on winning customers and nothing like enough time and money on keeping them. This behaviour is as pointless as pouring water, or perhaps molten gold might be a better material to keep in mind, into a bucket with a big hole in the bottom. You need most if not all of the flow to keep the bucket partially full. However fast the flow in, the flow out is just as fast.

Virtually all managers agree that customer care is important. A recent survey of major British companies showed that 75 per cent had recently instituted customer care quality schemes. Sadly, another survey, conducted by American consultancy company Bain, also revealed that less than a third of those companies saw any payback for their efforts in terms of improved market share or profitability.

Bain suggests that the reason companies are disappointed with their attempts to improve customer care is that they don't have anything tangible to measure. To help overcome that problem, it suggests that managers focus on the Customer Retention Ratio, a Bain invention. For example, if you have 100 customers in January and 110 in December, but only 85 of the original customers are still with you, then your retention rate is 85 per cent. Bain's study demonstrated that a 5 per cent improvement in retention had a fairly dramatic effect on clients. For a credit card client it boosted profits by 125 per cent; for an insurance broker a 5 per cent increase in profits occurred; and a software house benefited from a 35 per cent improvement in profits. Bain claims that the longer customers stay with you, the more profitable they become. The next section explains why.

Realising why retaining customers matters

Studies and common sense indicate several principal reasons for retaining customers being so vital:

- Acquiring new customers costs more than retaining the ones you have. What with market research, prospecting, selling time and so on, acquiring a new customer costs between three and seven times as much as retaining an old one.

  This is nothing more than the old military maxim applied by Montgomery, that attacking forces need several times the strength of the defenders to guarantee success.

- The longer you retain a customer, the more years you have to allocate the costs of acquiring that customer to. By spreading the costs of acquiring new customers over ten years, instead of one or two, the annual profit per customer is higher. Suppose it costs you £500 to get a new customer, and that customer makes you £1,000 profit each year you keep her. If you keep the customer one year, your annual profit is £500 (£1,000 minus £500). However, if you keep the customer ten years, your annual profit is £950 (£1,000 minus £500 ÷ 10). Customers who stay tend, over time, to spend more.

- Regular customers cost less to serve than new customers. Insurance and underwriting costs as a percentage of sales fall by 40 per cent for renewal policies, for example. You don't incur up-front costs again.

- Long-term customers are often willing to pay a premium for service. They're also less prone to check your competitors because they know and like you.

Avoiding the consequences of losing customers is a powerful motivator for keeping in your customers' good graces. Some of those consequences are:

- Dissatisfied customers tell between 8 and 15 others about their experience. Just avoiding this negative publicity has a value.
- Your former customers are fertile ground for your competitors. If you keep your customers, your competitors have to offer inducements to dislodge those customers and this is expensive and time-consuming.

Working to retain customers

Use these five rules to make sure that you retain customers and so improve your profit growth:

- Make customer care and retention a specific goal, and reward people for keeping customers, not just for getting them in the first place.
- Find out why you lose customers. Don't just let them go – either send them a follow-up questionnaire or get someone other than the salesperson concerned to visit former customers to find out why they changed supplier. You may be surprised how pleased people are to tell you why they didn't stay with you, if you explain that it may help you serve them better the next time. QuestionPro, a web-based service for conducting online surveys, has a number of customer satisfaction survey templates that you can download for free (go to www.questionpro.com/akira/showArticle.do). Also see 'Conducting the research' in Chapter 4 for more ideas.

- Research your competitors' service levels as well as their products. If practical, buy from them on a regular basis. If you can't buy from competitors, keep close to people who do.
- If one part of your organisation is good at caring for customers, get people there to teach everyone else what they do.
- Recognise that the best people to provide customer care are those who work directly with customers. But this means that you have to train them and give them the authority to make decisions on the spot. Aloof or indifferent employees don't convince customers that you really want to keep their business.

Retaining customers isn't the passive activity it sounds. The next sections offer concrete ways to keep your customers happy.

Giving customers opportunities to complain

One entrepreneur who's more than aware of the problems (and incidentally opportunities) presented by complaints is Julian Richer, founder of the retail hi-fi chain Richer Sounds. His maxim is that his staff should maximise customers' opportunities to complain. The operative word in that sentence is *opportunities*, which you shouldn't confuse with *reasons.* In order to put this policy into effect, Richer uses a range of techniques. The whole customer satisfaction monitoring process starts from the moment customers enter one of his retail outlets. A sign near the door invites people to ring a bell if they have had particularly good service or help while in the shop. That help may be simply getting some great advice, or finding a product they want to buy at a very competitive price.

Customers find that when they get their hi-fi equipment home it contains a short questionnaire on a postcard asking them for their immediate post-purchase feelings. Does the product work as specified, is it damaged in any way, were they delighted with the service they received? The postcard is addressed to 'Julian Richer, Founder' and not, as is the case with so many other big businesses, to 'Customer Services, Department 126754, PO Box, blah blah blah'.

Richer does surveys on customer satisfaction and encourages his staff to come up with their own ideas for monitoring customer reactions. In fact, he insists that they hit minimum targets for getting customer feedback. Silence on the customer satisfaction front isn't an option for management in his business.

Monitoring complaints

One terrifying statistic is that 98 per cent of complaints never happen. People just don't get round to making the complaint, or worse still, they can find no one to complain to. You'd have to be a hermit never to have experienced something to complain about, but just try finding someone to complain to at 8 p.m. on a Sunday at Paddington Station and you get a fair impression of how being in the Gobi Desert feels.

You can never be confident that just because you're not hearing complaints your customers and clients aren't dissatisfied and about to defect. Not making complaints also doesn't mean that they may not run around bad mouthing you and your business. Remember that on average people share their complaint with a score of others, who in turn are equally eager to share the bad experience. The viral effect of email has the potential to make any particularly juicy story run around the world in days if not hours.

Set up a system to ensure that your customers have ample opportunity to let you know what they think about your product or service. This may involve a short questionnaire, a follow-up phone call or an area on your website devoted to customer feedback. As a bonus you may find you get some great ideas on how to improve your business.

Ninety-eight per cent of customers who have a complaint are prepared to buy from you again if you handle their complaint effectively and promptly. Not only do they buy from you again, but also they spread the gospel about how clever they were in getting you to respond to their complaint. Nothing makes people happier than having something to complain about that ends up costing them next to nothing.

Setting customer service standards

Customer service is all those activities that support a customer's purchase, from the time they become aware that you can supply them with a particular product or service, to the point at which they own that product or service and are able to enjoy all the benefits they were led to believe were on offer.

The largest part of the value of many products and services lies in how the company delivers customer service. This is also the area most likely to influence whether customers come back again or recommend you to others. Customer service works best when:

- Customers are encouraged to tell you about any problems.

- Customers know their rights and responsibilities from the beginning.
- Customers know the circumstances under which they're entitled to get their money back and how to take advantage of other rights.
- Customers feel in control. You're far better advised to provide a full refund if the customer is dissatisfied than to demand that the customer come up with a good reason for the refund. A refund, or any other recourse you offer, should be prompt.

Repeat business is another key profit maker. Repeat business comes from ensuring that customers are genuinely completely satisfied with – and preferably pleasantly surprised by – the quality of your product. Repeat sales save unnecessary expenditure on advertising and promotion to attract new customers.

As standards of living rise, quality, convenience and service are going to become even more important relative to price. An investment in a strategy of quality customer service now is an investment in greater future profitability.

You need to have a model to follow for effective customer service and you should consider using mystery shopping as a way to keep tabs on your customer service standards – both issues are covered in the next sections.

Customer service is often the difference between keeping customers for life and losing customers in droves. You and your staff have to deliver outstanding customer service at all times. In order to do this everyone has to know what the important elements of good customer service are and everyone needs to incorporate those elements into their everyday customer interactions.

The key elements of your customer service plan should include:

- **Initial contact:** The customer's first contact with staff creates a lasting impression and can win and sustain customers. All your staff need to be aware of how to handle enquiries quickly and competently. They should know how to leave potential customers feeling confident that their requirements can be met.
- **Information flow:** Keeping customers informed of where their orders are in the process influences their feelings about the way you do business. Your action plan needs to specify each step of your process – quotation; order confirmation; delivery notification; installation instructions. A regular flow of information throughout this period makes your customers feel that they matter to you.
- **Delivery:** Delivering the goods or service is a key part of customer service. Your product needs to be available in a timely manner, delivery lead times must be reasonable and the delivery itself must be in a way that meets the customer's requirements.
- **After-sales support:** Good coverage in areas such as maintenance, repairs, help lines, upgrade notification, instruction manuals, returns policy and fault tracing helps customers feel that you care about their total experience with your products and business.
- **Problem solving:** Often the acid test of customer service, your staff need to be able to recognise when a customer has a real crisis and what your procedure is for helping them.

High customer service standards enable many firms to charge a premium for their products. Yet in many ways, good customer service can be a nil-cost item. After all, answering the phone politely takes as much effort as doing so with a surly and off-putting tone. So improved customer service is one route to increased profitability.

Rewarding loyalty

The reasons that loyalty improves profitability are:

- Retaining customers costs less than finding and capturing new ones.
- Loyal customers tend to place larger orders.
- Loyal customers don’t always place price first, but new ones usually do.

So what works and what doesn’t when it comes to keeping customers loyal?

One of the ideas that hasn’t lived up to its promise is customer loyalty cards. When they were launched, retailers made big claims about how they were going to gather tons of invaluable data about customers. But mostly they possess no more than huge virtual warehouses of information that hasn’t been used.

Analysing the buying habits of millions of shoppers as their cards are swiped at the till can be prohibitively expensive and few companies have used much of the data gathered to make their customers feel special and hence want to stay loyal.

Asked to give reasons for their loyalty, the top five elements consumers list are:

- Convenience
- Price

- Range
- Customer service
- Quality

What this means is that you have to get your basic marketing strategy right and understand what your customers want and how much they're prepared to pay. If that's wrong, no loyalty scheme is going to keep them on board. Customer service and quality are about getting things right first time, every time. So always under-promise and over-deliver.

Care and help lines, where customers are encouraged to call for advice, information or help with problems, help keep customers loyal and make them more likely to buy from you in the future. If the line is a freephone service it's even more effective.

Keeping in touch with customers can also bind them more securely. Questionnaires, newsletters, magazines, letters about incentives, customer service calls, invitations to sales events and 'member get member' schemes are all ways of achieving this result.

Improving Productivity

Improving productivity is a constant requirement for a growth-minded business, not simply an activity during periods of economic recession (when it is still, nonetheless, important – much better than adopting the 'turtle position', pulling in your head and your hands and getting off the road!). You need to improve productivity by acting on both your costs and your margins.

You can increase margins by changing the mix of products and services you sell to focus on those yielding the best return, or by raising your selling price. Cutting costs has the merit of showing quick and certain returns.

Trimming expenses

You need continually to keep expenses under tight control and balance them against the requirements for good quality and good service. In particular, you need to separate and act on your variable and fixed costs (see Chapter 13 for more on fixed and variable costs).

> *Variable cost* cutting is always in evidence in a recession; witness the automotive and banking staff cuts in the early 1990s, in 2002–2003 and with a vengeance in 2009–2010. Cutting variable costs includes such things as wages and materials that are directly related to the volume of sales.

Cutting fixed costs such as cars, computers and equipment – costs that don’t change directly with the volume of sales – shouldn’t include scrapping investments in technology that may bring economies and extra nimbleness in the future (like flexible-manufacturing facilities, where, for example, Peugeot has invested in product lines that can turn out two models of vehicle at once).

Equally, alliances between firms, aiming to reduce fixed-cost investments, can be advantageous. In the soft drinks industry, Perrier provides distribution for Pepsi in France, and Bulmers reciprocates for Perrier in England, avoiding the need for extra investment in warehousing and transport.

Focusing attention on the 20 per cent of items that make up 80 per cent of your costs probably yields your biggest savings. The 80/20 rule is helpful in getting costs back into line, but what if the line was completely wrong in the first place?

Increasing margins

To achieve increased *profit margins*, which is the difference between the costs associated with the product or service you sell and the price you get in the market, you need first to review your sales. This requires accurate costs and gross margins for each of your products or services (see Chapter 12). Armed with that information, you can select particular product groups or market segments that are less price sensitive and potentially more profitable.

> No one rushes out to buy expensive, overpriced products when cheaper alternatives that are just as good are readily available. The chances are that your most profitable products are also the ones that your customers value the most. You should start your efforts to increase margins by concentrating on trying to sell the products and services that make you the most money.

Pricing is the biggest decision your business has to make, and one it needs to keep constantly under review. Your decision on pricing is the one that has the biggest impact on company profitability. Try the consultants' favourite exercise of computing and comparing the impact on profits of a 5 per cent:

- Cut in your overheads
- Increase in volume sales
- Cut in materials purchased

- Price increase

All these actions are usually considered to be within an owner-manager's normal reach. Almost invariably, the 5 per cent price increase scores the highest, because it passes straight to the net profit, the bottom line. Even if volume falls, because of the effect that price has on growth margin, you usually gain more profit from selling fewer items at a higher price. For example, at a constant gross margin of 30 per cent with a 5 per cent price increase, profits are unchanged even if sales decline 14 per cent. Yet if prices are cut 5 per cent, an extra 21 per cent increase in sales is needed to make the same amount of profit. (See also the section about accounting for pricing in Chapter 13.)

Frequently, resistance to increasing prices, even in the face of inflationary cost rises, can come from your own team members, eager to apportion blame for performance lapses. In these instances making detailed price comparisons with competitors is important.

Working smarter

Making more money doesn't always have to mean working longer hours. You can just work smarter – and who knows, you may even end up working fewer hours than you do now and still make more money.

One way to get everyone's grey matter working overtime is to create 'smart circles', comprising people working in different areas of your business who you challenge to come up with ideas to make the business better (and smart rewards, which include extra resources, holidays and recognition for their achievements, rather than cash). You can formalise the process of encouraging employees to rethink the way they work and reward them in a way that makes their working environment better still.

Rewarding results

If you can get the people who work for you to increase their output, you can improve productivity. The maxim ‘What gets measured gets done and what gets rewarded gets done again’ is the guiding principle behind rewards, and setting objectives is the starting point in the process. You can read about some of the types of reward schemes common in small businesses in Chapter 11.

The objectives you want people to achieve in order to reward them beyond their basic pay need to be challenging but achievable too, which is something of a contradiction in terms. Problems start to arise as soon as professional managers and supervisors come on board with experience of working in big companies. They, and probably you, tend to take objectives and the ensuing budgets very seriously. You have to hit the budgets, so it makes sense to pitch them on the conservative side.

But in a small business, growth and improvement percentages have the potential to be much greater than in larger firms. A big business with a third of its market can only grow very quickly by acquisition or if the market itself is growing very fast. A small firm, on the other hand, can grow by very large amounts very quickly. Moving from 0.01 per cent of a market to 0.02 per cent is hardly likely to upset many other players, but it can represent a doubling in size for a small firm. However, exceptional performance, even in a small firm, is only attainable with breakthrough thinking and performance. The question may not be how to grow the business by 20 per cent a year, but how to grow it by 20 per cent a month.

Nevertheless, if you set goals too aggressively people may leave. Even, perhaps especially, great performers balk if the hurdle is put too high.

Rewarding excellent results

Nick White's Ecotravel company sends people to off-the-beaten-track exotic locations and to conservation areas where money goes into research projects. Ecotourists who book with Ecotravel pay to see animals in conservation areas and a proportion of the money they spend on the holiday goes directly to conservation projects.

White expanded the business slowly, until two years ago when he introduced a 'rewarding excellence' initiative and sales shot up by 40 per cent in just six months. The basis of the reward is an accelerating bonus. If the company hits its sales targets, staff share in a 5 per cent bonus. If it exceeds targets, the bonus rates rise too. For every 20 per cent of achievement above target, the bonus rate goes up 1 per cent. Targets are reset each year using a similar formula, but starting from a new and higher base level.

One way to get the best of both worlds is to have a performance band rather than just one number. The reward for achieving a really great result should be massive, but if the employee misses this high goal slightly, you reward her as if the goal had been set at the level she reached. The reward is proportionately smaller, so your rewards budget still balances. This technique can get an 'inspiration dividend'. You can persuade teams to set higher goals than they may otherwise have set, and even if they miss them, the year-on-year improvements can be stunning.

Budgeting for Beginners

One sure-fire way to get poor performance back on track or, better still, to turn satisfactory results into exceptional ones is to set specific goals to make that happen. Sure, you have a long term business plan that looks out to the distant horizon (I cover this in Chapter 6). But you also need something with a bit more immediacy and a whole lot of bite. In the business word this process is known as *budgeting*. Budgets set goals in terms of revenues and expenses for the year ahead and are usually reviewed at least halfway through the year and often quarterly. At that review you can add a further quarter or half year to the budget to maintain a one-year budget horizon. This is known in the trade as a *rolling quarterly (half yearly) budget*.

You can think of a budget as doing much the same as a coach does with an athlete in setting improvement targets to be achieved by some specific date in the future. Then the coach gets a stopwatch out, checks on performance and cheers or cajoles as the situation warrants.

Setting the guidelines

Budgets should adhere to the following general principles:

- Budgets should be based on realistic but challenging goals. Those goals are combine both a top-down aspiration of the boss (you) and a bottom-up forecast of what the employees or departments concerned see as possible.
- It should be prepared by those responsible for delivering the results – the salespeople should prepare the sales budget and the production people the production budget.

- Agreement to the budget should be explicit. During the budgeting process, several versions of a particular budget should be discussed. For example, the boss wants a sales figure of £20,000 but the sales team's initial forecast is for £15,000. After some debate, £18,000 is the figure agreed upon. After a figure is agreed, a virtual contract exists that declares a commitment from employees to achieve the target and commitments from the employer to be satisfied with the target and to supply resources in order to achieve it. It makes sense for this contract to be in writing.
- The budget needs to be finalised at least a month before the start of the year and not weeks or months into the year.
- The budget should undergo fundamental reviews periodically throughout the year to make sure all the basic assumptions that underpin it still hold good.
- Accurate information reviewing performance against budgets should be available seven to ten working days after the month's end.

Analysing the variances

Understanding variances is a key task, so as the boss you need carefully monitor and compare performance against the budget as the year proceeds, taking corrective action where necessary. You do this on a monthly basis (or using shorter time intervals if required), showing both the company's performance during the month in question and throughout the year so far.

Looking at Table 16-1, you can see at a glance that the business is behind on sales for this month, but ahead on the yearly target. The convention is to put all unfavourable variations in brackets. Hence, a higher-than-budgeted sales figure doesn't have brackets, but a higher materials cost does. You can also see that although profit is running ahead of budget, the profit margin is slightly behind (–0.30 per cent). This is partly because other direct costs, such as labour and distribution in this example, are running well ahead of budget.

Table 16-1 The Fixed Budget in £'000s

	Month			***Year to Date***		
	Budget	Actual	Variance	Budget	Actual	Variance
Sales	805	753	(52)	6,358	7,314	965
Materials	627 (78%)	567	60	4,942	5,704	(762)
Less cost of materials	178 (22%)	186	8	1,416	1,610	194
Direct costs	74	79	(5)	595	689	(94)
Gross profit	104	107	3	820	921	101
Percentage	12.92	14.21	1.29	12.90	12.60	(0.30)

Flexing the figures

A budget is based on a particular set of sales goals, few of which are likely to be exactly met in practice. Table 16-1 shows a company that's used £762,000 more materials than budgeted (See variance column under Year to Date. Because more has been sold than was budgeted for, this is hardly surprising. The way to manage this situation is to flex the budget to show what, given the sales that actually occurred, would be expected to happen to expenses. Applying the budget ratios to the actual data does this. For example, materials were planned to be 78 per cent of sales in the budget. By applying that to the actual month's sales, you arrive at a materials cost of £587,000 (78% of £753).

Looking at the flexed budget in Table 16-2 , you can see that the company has spent £19,000 more than expected on the material given the level of sales actually achieved, rather than the £762,000 overspend shown in the fixed budget.

The same principle holds for other direct costs, which appear to be running £94,000 over budget for the year. When you take into account the extra sales shown in the flexed budget, you can see that the company has actually spent £4,000 over budget on direct costs. Although this is serious, it’s not as serious as the fixed budget suggests.

The flexed budget allows you to concentrate your efforts on dealing with true variances in performance.

Table 16-2 The Flexed Budget in £’000s

	Month			***Year to Date***		
	Budget	Actual	Variance	Budget	Actual	Variance
Sales	753	753	-	7,314	7,314	-
Materials	587	567	20	5,685	5,704	(19)
Materials	166	186	20	1,629	1,610	(19)
Direct costs	69	79	(10)	685	689	(4)
Gross profit	97	107	10	944	921	(23)
Percentage	12.92	14.21	1.29	12.90	12.60	(0.30)

The SCORE website has a downloadable Excel spreadsheet from which you can make sales and cost projections on a trial and error basis (www.score.org; go to Business Tools, Template Gallery and then Sales Forecast). When you’re satisfied with your projection, use the profit and loss projection (Template Gallery, then Profit and Loss Projection [3 Years]) to complete your budget.

The figures shown for each period of the budget aren’t the same. For example, a sales budget of £1.2 million for the year doesn’t translate to £100,000 a month. The exact figure depends on two factors:

- The projected trend may forecast that although sales at the start of the year may be £80,000 a month they will change to £120,000 a month by the end of the year. Sure, the average would be £100,000, but month by month the budget figure against which performance should be measured is going up.
- By virtue of seasonal factors, each month may also be adjusted up or down from the underlying trend. For example, you could expect the sales of heating oil to peak in the autumn and tail off in the late spring.

Budgeting from zero

When you sit down with your team and discuss budgets, the arguments always revolve around how much more each section needs next year. The starting point is usually this year’s costs, which are taken as the only facts on which to build. So, for example, if you spent £25,000 on advertising last year and achieved sales of £1 million, your advertising expense was 2.5 per cent of sales. If the sales budget for next year is £1.5 million, then it seems logical to spend £37,500 next year on advertising. That, however, presupposes that you spent last year’s sum wisely and effectively in the first place, which you almost certainly did not.

Zero-based budgeting turns the cost argument on its head. It assumes that each year every cost centre starts from zero spending and, based on the goals of the business and the resources available, presents arguments for every pound you're planning to spend, *not just for the increase*. So each year starts out with a blank sheet of paper rather than last year's figures.

Chapter 17

Exploring Strategies for Growth

In This Chapter

- Seeing why market share matters
- Recognising the value in brands
- Discovering ways to sell more
- Checking out market growth strategies
- Getting into alliances
- Looking at franchising opportunities

If you thought it was hard work getting your business off the ground, 'you ain't seen nothing yet'. In periods when economic growth is strong it may be possible to increase sales without too much effort, being swept along on a benevolent tide. But that route to increasing sales won't help a business to outperform its competitors or to increase market share, which is vital if a business is to achieve superior long-term performance. Nor will going with the flow be a great success if the economy is experiencing a downturn. In this chapter I tell you why growth is vital to maintain a firm's competitive edge.

Also, without growth you can't provide opportunities for development and advancement for the staff you took so much care in recruiting (I cover this in Chapter 11) and a business is only as good as the people it employs. The budget (see Chapter 16) sets the goals for the business and allows you to track performance against those goals. But you still need strategies to meet your goals and that's what this chapter is all about.

Understanding the Importance of Growth

Growth is the natural path for a healthy business. Too little and the firm atrophies and dies; too much and it's in danger of exploding. How much growth is enough depends on market conditions, the aspirations of the boss – you – and your key employees. You hopefully want to enjoy the fruits of your labours and have a valuable business either to pass on to your family or to sell up and retire on the proceeds, and to achieve those aims the business needs to grow.

Back in the 1960s a smart firm of American management consultants, Boston Consulting Group (BCG), observed a consistent relationship between the cost of producing an item (or delivering a service) and the total quantity produced over the life of the product or service concerned. BCG noticed that total unit costs (labour and materials) fell by between 20 per cent and 30 per cent for every doubling of the cumulative quantity produced. So any company capturing a sizeable market share has an implied cost advantage over any competitor with a smaller market share. You can then use that cost advantage to make more profit, lower prices and compete for an even greater share of the market or invest in making the product better, so stealing a march on competitors. And so it became imperative for firms to get on the growth treadmill.

Measuring market share

You can't set any realistic market share goals until you've made some attempt at measuring the size of the market. Now, in principle this isn't too difficult. I cover the market research process that helps you unravel such facts in Chapter 4.

Here's an example. Using market research you'd be able to discover that the consumption of bread in Europe in 2010 was worth £10 billion a year.

First, to make much sense of that bald figure, you need a definition of bread. The industry-wide definition of *bakery*, a term used to cover the whole bread market, includes sliced and un-sliced bread, rolls, bakery snacks and specialty breads. It covers both plant-baked products, those that are baked by in-store bakers, and products sold through craft bakers.

It's unlikely as a newish small firm that you'll be in every segment of that market. So you need to sift through the figures to arrive at the market relevant to you. This involves refining global statistics down to provide the real scope of your market. If your business only operates in the UK, the portion of the European market open to you is worth around £2.7 billion, equivalent to 12 million loaves a day, one of the largest sectors in the food industry. If you're only operating in the craft bakery segment then the data shows that the relevant market shrinks down to £13.5 million; this contracts down still further to £9.7 million if you're, say, only operating within the radius of the M25 ring road. That in turn means that if you have annual sales of £500,000 you have just over 5 per cent of the market ($500,000 \div 9,700,000 \times 100$). Now 5 per cent isn't a dominant market share by any measure, but it's a whole lot bigger than the share you'd have if you used £10 billion as the base line.

Various competing businesses share your relevant market in different proportions. Typically, you find a market leader, a couple of market followers and a host of businesses trailing in their wake. The slice each competitor has of a market is its *market share*. You find that marketing people are fixated on market share, perhaps even more so than on absolute sales. That may appear little more than a rational desire to beat the ‘enemy’ and appear higher in rankings, but it has a much more deep-seated and profound logic, as BCG uncovered.

You can read up more on the importance of market share and how BCG used it to evaluate product growth strategies at the NetMBA website (www.netmba.com/strategy/matrix/bcg).

Building a brand

People consider the brand to be the holy grail of successful business growth. A brand encompasses not just what a product is or does but all the elements such as logo, symbols, image, reputation and associations. Branding is an intangible way of differentiating a product in a way that captures and retains markets through loyalty to that brand. McDonald’s arches represent its brand as a welcoming beacon, drawing customers in. Coca-Cola tastes little different from a supermarket brand, but the promotion that supports the brand confers on the consumer the chance to share the attractive lifestyle of those ‘cool’ people in the adverts. Apple’s iPod is differentiated from just any old MP3 player in much the same way. Intel and Audi are examples of branding designed to reassure consumers in unfamiliar territory that a product will deliver. And Body Shop International exudes ethics and concern for the environment, where other cosmetics concentrate on how they make the wearer look beautiful.

The economic crisis that engulfed the world at the end of the first decade of the 21st century proved the enduring value of having a successful brand. Here you could aptly apply investor Warren Buffet’s statement, ‘It’s not until the tide goes out that you can see who is swimming naked.’ The share prices of the top 100 brands as identified in BrandZ’s (www.brandz.com) annual study have outperformed the S&P 500 (Standard and Poors, a financial services company that provides stock market indices) by over 30 per cent over the period 2005–2010. In fact, although companies in the S&P 500 lost 11.5 per cent in value, those of the top 100 brands gained 18.5 per cent.

Building a brand takes time and a considerable advertising budget. But by creating brand value – that's the price premium commanded by that product over its unbranded or less appealing competitors – a business can end up with a valuable asset.

Superbrands (www.superbrands.com) has a listing of the top brands by country, often with a case study supporting the top brands in any country.

Increasing Sales

The most obvious way to grow a business and improve market share is to get more sales. This is often easier said than done, but some tried and proven techniques usually deliver the goods. A helpful framework to keep in mind is the growth matrix developed by business guru Igor Ansoff.

Ansoff's model has four main elements:

- **Business development**, which is about getting more customers like the ones you already have and getting them to buy more from you.
- **Market development**, which involves entering new markets in your home country or overseas.

- **Product or service development**, which involves launching new products or extensions to existing products or services. A courier service adding an overnight delivery service to its existing 48-hour service is an example of this activity.
- **Diversification**, which means, in a nutshell, launching off into the unknown.

Getting customers to buy more

This is a no-brainer starting point for achieving profitable growth. Winning a new customer can be an expensive and time-consuming activity, so when you have a customer, the more you can get him to spend with you rather than a competitor, the better your bottom line is going to be.

Use this framework to categorise your customers and so ensure you keep them longer and that they buy more from you:

- **Courtship:** This is the stage before a customer has bought anything from you. At this stage the customer is suspicious and your objective is to get your first order. Any order is okay, just to get the relationship underway.
- **Engagement:** Having got your first order in the bag, your customer may still be moderately suspicious of you and unsure whether your intentions are wholly honourable. Your goal is to get your first repeat order and cement the relationship. Getting to this stage means that your first order must go well and your customer must be at least satisfied, or delighted if you want to get to the honeymoon stage in your relationship. To make that happen, you need to stand out from the crowd and go the extra mile to make that customer feel special by meeting his particular needs.

- **Honeymoon:** With several repeat orders successfully fulfilled, your customer now trusts you and is susceptible to new ideas. Here you should be looking to increase sales volume. Almost certainly, as a new supplier your customer hasn't put all his eggs in your basket. Now your task is to get as many eggs as you can and build up to being the customer's preferred and perhaps only supplier.
- **Wedlock:** When you first started talking to your customer you were the new kid on the block, to the customer at least. Your ideas and products or services were refreshingly new and the customer's existing suppliers had had ample opportunity to disappoint him and let him down. Now you've become, or are fast becoming, that old, boring supplier. You need to think of ways to keep your relationship exciting and fresh.
- **Deadlock:** Your customer has become disenchanted and is considering divorce. The time has come to bring on new products and services to whet the customer's appetite and make him see you as the exciting, vigorous supplier you appeared to be when your relationship started.

Encouraging referrals

Referrals are the most valuable marketing asset any business can have. Whether you're selling direct to an end consumer or user, or operating in the business-to-business arena, your goal is the same – to get those using your product or service to talk in glowing terms about their experience with your business.

Passive word of mouth is rarely as effective as encouraging satisfied customers to pass on the glad tidings. Happy customers tell an average of seven other people if they've had a positive experience with you. Unhappy customers tell 11 to 20 other people.

You can make word-of-mouth advertising work, however. You just require discipline and a programmed effort to ask your customers for referrals. Make it easy for them – give them brochures, flyers, samples or whatever they need to make your case. Then follow up.

Angus Thirlwell and Peter Harris, founders of Hotel Chocolat (www.hotelchocolat.co.uk), have a neat method of getting customers to promote their luxury home-delivered chocolate business. They started a number of tasting clubs that have attracted well over 100,000 regular members, who enjoy a brand new selection of exciting, artisan chocolates every month. The idea is that members receive a selection of chocolates together with a scoring card, and then invite their friends to taste and rate the selection. In the process, new members are recruited to the club.

Discounts for introductions come out of your advertising budget. So you need to work out how much an introduction to a prospect is worth before you can decide on the discount. The rules to follow are:

- Be specific in the type of introductions you want. In particular, make the sales volume and product specifications clear. Giving a discount for products on which your margins are already tight is a pointless exercise.

- Have a sliding scale of discounts. The more introductions you get, the more discount you give.
- Make giving you introductions easy for people. Send them fax-back forms or have a place on your website for them to tap in minimal details. A name and company should be enough for you to find the other details you need.
- Follow up and let people know that their introduction paid off. People are usually interested in more than just the discount when they give introductions.
- Have a specific programme such as member-gets-member and run it as a campaign for a set period. Then change the programme and the discounts. That keeps people interested.
- Give the discount promptly, but not until the new introduction has bought and paid his bill.
- Give extra discounts for introductions to loyal customers, perhaps when the new customer has placed his third or fourth order.
- Research the market and find out what introductory schemes are on offer in your sector.
- Set up a database to monitor the effectiveness of your introductory discount scheme.

Entering new markets at home

Generally, the most rewarding market growth for small businesses comes in its first few months and years, when the whole of what's known as the home market is up for grabs. You may find it profitable to enter new markets, which can take a number of shapes. The two most common are:

- **Geographic:** When you're confident that you've extracted as much business as you can from your immediate business area, be that a town, city or region, move on to another one. You need to make sure that the new geographic area is broadly similar to the one you've been successful in already. For example, Bristol and Bath are broadly similar to Bradford and Sheffield as cities, but if your business has tourists as customers, the last two cities are less appealing as a new market than the first two.
- **Demographic:** This covers factors particular to customer groups. If you make clothes for women in Bristol, you can consider making clothes for children, men or teenagers, sticking to the Bristol area.

You can get help and advice from Business Link (www.businesslink.gov.uk), which can provide practical support in this area and in most other areas of marketing your business.

Selling overseas

You may want to explore the possibilities of expanding your business to other countries. Financial information website Motley Fool's entry into the German market involved a modest change in a well-proven product, as for its entry into the British, French and Italian markets, changing little except the language on its website. But expanding overseas isn't quite as easy as it looks.

Marks & Spencer made a mess of its foray into America and retired in some ignominy from the French market, closing 38 stores virtually overnight and exciting the wrath of the French trade unions on the way. The Body Shop, a world business if ever there was one, found the French market hard going, because there people take beauty, as they do wine, rather more seriously than most.

Don't let these stories of failure discourage you. After all, millions of businesses export successfully and you can always find some help in getting started. UK Trade and Investment (www.uktradeinvest.gov.uk), the government's export advisory organisation, can put a package of help together for you.

Adding new products or services

At one end of a spectrum of innovation are truly new products; at the other end are relatively modest product or service line extensions. For example, Amazon's music and video/DVD business can be seen as a product line extension of its book trade. Its tools and hardware operation looks more like a new product – new to that company, of course, not to the thousands of other businesses in that sector.

Most new products are unsuccessful. A new product has to be two or three times better in some respect – price, performance, convenience, availability – to dislodge a well-entrenched rival.

They don't necessarily have to be your new products and services, of course. Alliances, affiliations, joint ventures and the like abound and may help you to be even more successful.

TIP The sources of successful new products include:

- Customers can tell you their needs and dissatisfactions with current products and services, if you listen to them.
- Your sales team are also close to the market and so can form a view as to what may sell well.

- Competitors who are first to market usually make lots of mistakes on the way. Following in their wake you can avoid the worst of their errors and succeed where they haven't.
- Exhibitions and trade fairs are where other firms, not necessarily competitors but those on the margins of your sector, meet and exchange ideas. You can adapt products and services that work well in one environment for use in your market at little cost.
- Other markets may be in advance of your own. Many new ideas start their lives in America and only arrive in Europe 18 months to five years later. Following trends there gives you useful pointers for successful new products in your own market.
- Research and development departments often throw up innovative ideas for which no obvious market need exists. You may know of profitable ways to exploit those technologies.

Diversifying as a last resort

Diversification involves moving away from the products, services and markets in which you currently operate to completely new areas of business. This is the riskiest strategy of all – selling things you know little about to people you know even less about. Sure, you can do market research and buy in industry expertise, but risk still exists.

Companies that succeed in diversifying do so slowly, sometimes by acquisition, and above all by listening to customers and front-line staff.

Unless you can quantify the value added in an acquisition or diversification, for example in better buying with quantity discounts or by being able to spread your costs over a bigger sales volume, don’t bother.

However, if you can get acquisitions right, the growth through diversification can be phenomenal.

Forming Alliances

Alliances come in a variety of different forms and in theory can prove one way of pumping some steroids into your growth strategy.

Before I look at this strategic option in a little more detail it would be as well to be clear on what types of alliance are usually on offer:

- An ***acquisition*** occurs when one company buys another – more often than not in a ‘friendly’ deal, but sometimes events aren’t so harmonious. After the acquisition only the parent company usually exists in any real legal sense and the top management of the ‘victim’ usually depart quickly.
- ***Mergers*** are friendly bids where companies join forces and the separate identities of the businesses of the companies concerned continue after the deal is consummated.
- ***Joint ventures*** occur when two or more companies decide to set up a separate third business to exploit something together. There may be no attempt to harmonise the whole of the two parent businesses, and

the joint venture may be disbanded when the reasons they joined forces in the first place disappear.

Carlos Ghosn's alliance forged between Nissan, owned 44 per cent by Renault, which in turn owns 15 per cent of Nissan, is an example of a successful joint venture. These companies have joint purchasing and share engineering know-how. Both companies have separate joint ventures with other parties. Nissan has a joint venture with Dongfeng Motor Corporation, an important Chinese car maker. Nissan also has a 25 per cent stake in Avtovaz, a big Russian car manufacturer in need of all the help it can get. Renault has a three-way joint venture with Nissan from buying Daimler, a German truck and luxury car firm, after that company failed to negotiate a deal with Volkswagen.

Although such alliances are popular with professional managers, the research literature produces, at best, inconclusive evidence to support the hypothesis that alliances generally create increased shareholder value for the owners of the acquiring firm. Since John Kitching's seminal work 'Why do mergers miscarry?' (published in Harvard Business Review in 1967) a big question mark has hung over the subject of acquisitions and shareholder value. In 1987 Michael E. Porter concluded in the Harvard Business Review that 'acquisitions have been largely unsuccessful, when one considers that over half were subsequently divested'. A clear majority of the academic studies published over the past 50 years come down on the side of the doubters.

Going on the alliance trail

Okay, so you parked your worries about the relatively low chances of success and decided to get out in the big outside world and either buy or buddy up with some other players. Here are the ground rules.

Knowing why you want to buy or buddy up

Ideally, the reasons to buy or buddy up to a business need to be practical and down-to-earth and embedded in the firm's core strategy. Sound reasons for acquisitions include the following:

- To increase market share and eliminate a troublesome competitor
- To broaden your product range or give you access to new markets
- To diversify into new markets, acquiring the necessary management, marketing or technical skills to enable you to capture a reasonable slice of the market, relatively quickly
- To get into another country or region
- To protect an important source of supply that could be under threat from a competitor
- To acquire additional staff, factory space, warehousing or distribution channels, or to get access to additional major customers more quickly than by starting up yourself

Produce a written statement explaining the rationale behind your reason to buy or buddy before you start looking for targets. Otherwise you could end up pursuing a bargain that has absolutely nothing to do with your previously defined commercial goals just because it seems cheap. Also remember that companies available at knockdown prices are likely to need drastic surgery. So unless you fancy your chances as a company doctor, stay well away.

Deciding what you want to buy or buddy with

It can take over one year of work, on average, to find and buy a business. The more accurately you describe your ideal purchase, the simpler, quicker and cheaper your search is. Just imagine trying to buy a house without any idea where you want to live, how much you want to spend, how many bedrooms you need, whether you want a new house or a listed building, or whether you want a garden. The search would be near impossible to organise, it could take forever and the resultant purchase would almost certainly please no one. The same problem is present when buying a company. The definition of what you want to buy should explain:

- Business area/products/service the company is in
- Location
- Price range and the cash you have available
- Management depth and the management style you're looking for
- Image compatibility between your company and any target
- Scope for integration and cost savings
- Tax status – for example, a business nursing a substantial loss could be worth looking at if you can offset the loss against your company's profits and so reduce tax due

- Minimum profitability and return on capital employed you could accept.

  If the company you plan to buy only makes 1 per cent profit but you make 5 per cent, and you're of equal size, the resultant profit will be 3 per cent (5 + 1 ÷ 2. I cover this subject in Chapter 13.

Outside of the factors listed in these bullet points, you may have vital reasons that, if not met, would make the target a poor bet. For example, if you want to iron out major cash flow or plant capacity cycles, there's little point in going for a business similar to your own. That will only make the peaks and troughs more pronounced.

The Leadership Factor (www.leadershipfactor.co.uk), founded in Huddersfield 11 years ago by Nigel and Janet Hill, specialises in a niche area of market research: customer satisfaction. Nigel got the idea from the US where it was already a well-established business, and he could see he could start the business with relatively little up-front investment. The Leadership Factor now conducts 200 customer satisfaction surveys each year, using a database of 250,000 respondents. With a turnover of £3.7 million and a blue chip customer base, the Hills have fuelled their expansion by buying stakes in similar companies selling the same product in Spain, Australia and the USA. They're licensing their business model in other less developed markets such as Russia and the Ukraine. This strategy of buying into competitors has added £1 million to turnover.

Investigating and approaching

After you have your shopping list of prospective targets you need to arm yourself with everything you can find out about them. Get their literature, samples of any products, copies of their advertising, press comment and, of course, their accounts. Then get out and see their premises and as much of their operation as you can. If you can't get in, get one of your salespeople in to look the business over for you. This investigation helps you both to shorten your shopping list and to put it into order of priority. Now you're ready for the approach. I cover the research tools you need to deploy here in Chapter 4.

You have three options as to how to make the initial approach and each has its merits:

- **Telephone**, giving only the broadest reason for your approach – saying, perhaps, that you wish to discuss areas of common interest.
- **Write** and be specific on your purpose, following that up with a phone call to arrange a meeting, perhaps over lunch.
- **Use a third party** such as an accountant or consultant (reasons of secrecy could make this method desirable) or a corporate finance house. If executive time is at a premium, no other practicable way may exist.

The first meeting is crucial and you need to achieve two objectives. First, you must establish mutual respect, trust and rapport. Nothing worthwhile follows without these. Then you need to establish in principle that both parties are seriously interested. You can sidestep time scale, price and methods of integration until later, except in the most general sense.

Valuing a target

Forming an alliance, be it a merger, acquisition or joint venture, involves you stumping up money. You need to be sure you're getting good value for your investment. I cover the tools for valuing a business in Chapter 22 and for assessing return on investment in Chapter 13.

Managing an alliance

However well negotiated the deal, most acquisitions and venture relationships that go wrong do so because of the human factor, often in the first few weeks and months after the deal is done. Have an outline plan for how to handle the relationship and be prepared to be flexible. (Interestingly enough, only one buyer in five has a detailed operational plan of how to manage their acquisition, yet 67 per cent of those being bought believe the buyer has such a plan, so the plan is psychologically important.)

Franchising Your Way to Growth

If your business concept looks as though it can be replicated in several other places, you have a number of choices. The most obvious is to open up more branches. But you can consider a faster, and in some ways safer, route by franchising your business for others to roll out and share the risk.

Franchising is a great way into business and it's a great way to grow a business too. Over 700 different types of franchise are on offer somewhere in the world, so you can almost certainly find one that suits your needs and aspirations.

JARGON ALERT

As a *franchiser* you supply a product or teach a service to a *franchisee*, who then sells your product or service to the public. In return for your input, the franchisee pays you a fee and a continuing royalty, based usually on turnover. You may also make additional money by ensuring the franchisee buys materials or ingredients from you.

You have two possible strategies for harnessing the power of franchising to your business. You can consider taking on a franchise or master franchise that's complementary to your existing business, or you can franchise your own business concept, taking on self-employed franchisees instead of hired-in managers to run your new branches or outlets.

Bolting on a franchise

Adding a franchise to your own business is a safer way to grow than franchising your own business idea. After all, after a franchise is up and running you can see how well it works. You can assess the franchise's track record, and though no guarantee of success exists, at least the franchise has ironed out many of the unknowns associated with any new venture. The following sections outline the two routes to deploying this growth strategy.

Adding a franchise

A few years back Harrods, London's up-market department store, opened the first British outlet of Krispy Kreme Doughnuts. For Harrods the sale of doughnuts is complementary to its other food and beverage sales, so the addition represents pure extra revenue. For Krispy Kreme, the venture represents a chance to enter the British market, which it believes is ripe for development with no dominant doughnut brand in the market.

The aim in adding a franchise to your existing business is to leverage, as the business gurus say, your customer or resource base, in order to get more sales per customer or square metre of space.

So if your customers are buying chocolate, sweets and stationery from you, adding a freezer with ice cream is no big deal. Chances are that the ice cream supplier is so keen to extend its distribution that it throws in the freezer cabinet for free. You're taking someone else's business model, product and support systems and bolting them on to your business to add turnover and profits.

Taking out a master franchise

Instead of just adding a franchise to complement your business, you can consider rolling out a chain of franchises. That involves taking a master franchise for a country or region. You can also look on this as a strategy for rapidly expanding your own business, if you can put it into a franchise format. I cover that aspect of expansion in 'Rolling out the franchise', later in this chapter.

You can find out more about taking on a master franchise from Master Franchises for Sale (www.masterfranchisesforsale.com), Franchise Solutions (http://uk.franchisesolutions.com) and Franchise Direct (www.franchisedirect.co.uk).

Weighing the advantages and disadvantages

From the franchiser's point of view, one huge financial advantage is that you don't have any direct investment in any of your franchises. The franchisee owns the inventory and equipment.

Because of the shortage of prime sites, one growing trend is for franchisers to acquire leases on behalf of franchisees, or at any rate to stand as guarantors. Nevertheless, the effect on the liquidity of the franchiser, in contrast to expansion by opening branches, is enormous.

However, you do face heavy start-up costs in piloting the franchise and in setting up and maintaining training if you do the job properly. Thereafter you incur further costs in providing a continuing service to franchisees in such matters as research and development, promotion, administrative back-up, and feedback and communication within the network.

As a franchiser, you're dependent on the willingness of the franchisee to observe the rules and play the game, and any failure of the franchisee to do so is equally and perhaps more damaging to you and to other franchisees than it is to the wayward franchisee.

Doing the pilot

After you've developed a franchise concept, you should run a pilot operation for at least a year. Someone as similar to the intended typical franchisee for the chain as is practical should run the pilot. The aim isn't just to test the business concept, but to see whether you've described the operating systems well enough for people outside the founding business organisation to run them.

Take as an example a fast-food outlet offering slimmers' lunches. You already own a couple of outlets for which you've found a catchy name, Calorie Counter. You've established a standard image in terms of decor, layout, tableware, menus and graphics, and your staff members have a stylish uniform. Your gimmick is that on the menu every dish has a calorie rating and a breakdown of the fibre and salt content, and along with their bill customers get a calorie and fibre count for what they've bought. You also have some recipes that you've pioneered.

In the year since you opened you've ironed out most of the start-up bugs and learned a lot about the catering, accounting and staffing problems in running a business of this kind.

The indication is that demand exists for more restaurants like yours, but you have neither the capital nor the inclination to take on restaurant managers. Being a thorough sort of person, you've documented every aspect of running your restaurant, covering everything from recipes, ingredients and cooking times, to opening hours, wages, incentives and dress code. You've also standardised your accounting system and linked the electronic till to your raw material and stock systems, so that you can order key ingredients automatically. From your experience in opening two of your own restaurants you know how and where to advertise, how much to spend and how sales demand is likely to grow in the early weeks and months. You've captured all this knowledge in a sort of manual, which you propose to use as a guide for whoever you select to open your next outlet.

You're now ready to run your first pilot franchise. This involves using your manual and procedures with a real live franchisee. True, you may have to give the franchisee some incentive to join you in the risk. But whatever you end up negotiating, as long as it gives you the benefits of franchising that I list in 'Weighing the advantages and disadvantages', earlier in this chapter, you're ahead of the game.

When your pilot franchisee gets underway you have the opportunity to test your manual in action. You, after all, invented the business, so you should know what to do in every situation – but seeing whether a green franchisee straight off the street can follow your ‘map’ and get a result is the acid test.

Put what you learn from the pilot into a revised franchise manual, sort out your charging and support systems and you’re ready to start to roll the franchise out.

Finding franchisees

Sorry, but the last sentence in the previous section was a bit misleading. Despite having a great business, a robust and proven business manual and a couple of pilot runs under your belt, you aren’t quite ready to roll the franchise out around the world, or even around your neighbourhood. The most recent NatWest/British Franchise Association survey (they do one every year and have done for the last 20) asked franchisers what they consider to be the biggest barrier to the growth of the number of franchises they operate. By far the greatest number of respondents – 41 per cent – said that it was the lack of suitable franchisees.

Visit any franchise exhibition – and you visit many if you’re serious about growing in this way – and the thousands of people milling around the stands and in the seminar rooms may convince you that no lack of interest exists among the general public to taking up a franchise.

TIP Finding potential franchisees isn’t a problem. Use the contact details in ‘Finding your way to franchising’ in Chapter 5, to advertise for applicants and attend as many exhibitions as you can and you should have applicants

> coming out of your ears. Yet turning that latent demand into done deals isn't so easy. One international franchise chain only offers franchises to 30 per cent of the people it interviews, and it only interviews a small fraction of the number of people it sees at exhibitions.

This begs the obvious question: what sort of person makes the ideal franchisee? Well, looking at past career patterns may not be much help. Les Gray, chairperson of Chemical Express, a 104-outlet cleaning products franchise chain, lists a postman, a sales manager, a buyer, a farmer and a shipping agent as the occupations of his most successful franchisees.

Franchisers say that they have the most success with franchisees who are motivated, able to work hard, have some management aptitude, good communication and people skills and are *not* too entrepreneurial. They aren't looking for people with relevant industry skills and experience, because they want to inculcate candidates into their own formula.

Look at Chapter 11 for some tips on how to recruit and select great people.

Rolling out the franchise

So now you have a proven formula and a steady stream of candidates, you really are ready for the big roll out Carefully select locations and areas that most closely fit your business model. For example, the Hard Rock Café model is known as a capital city business. In other words, room only exists for one in each major international city. ProntaPrint, on the other hand, can accommodate an outlet in each major business area within a city, or a single outlet in any major town with a population over around 30,000 people.

Your equation depends on your customer profile. A fast-print outlet may find the going tough in a seaside town with 20,000 pensioners and 10,000 holidaymakers.

Chapter 18

Becoming a Great Manager

In This Chapter

- Seeing why you need a team and how to build one
- Planning for your own successor
- Delegating effectively
- Developing the right leadership style
- Preparing for change

In business, one of the simplest profit calculations is profit per employee. Until you become a massive company with more than 500 employees, each employee you add increases your profit. Still, you needn't worry too much about what happens when you have 500 employees on your hands. Well, not in this book, anyway.

But employees aren't a trouble-free resource. To maximise the employee–profit ratio, you have to manage your employees so that they produce quality work for you. You have to build them into teams, and lead and manage them to prepare them for the roller-coaster life of change that is the inevitable lot of a small, growing business.

In this chapter, I give you the tools you need to become a successful and effective manager.

Building a Team

Teams are a powerful way to get superb results out of even the most average individual employees. With effective teamwork, a small firm can raise its efficiency levels to world-class standards. Some small firms have built their entire success around teams.

A group of people working together isn't necessarily a team. A successful sports team has the right number of players for the game, each with a clearly defined role. The team has a coach, to train and improve players' performances, and measurable goals to achieve in the shape of obvious competitors to beat. Contrast that with the situation that usually prevails in a typical small firm. The number of players is the number who turn up on a particular day, and few have specific roles to play. Some are trained and properly equipped and some aren't. For the most part the business's objectives aren't clearly explained to employees, nor are any performance-measuring tools disclosed. Most of the players in the home team are highly likely not even to know the name or characteristics of the enemy against whom they're competing.

Clearly, a successful sports team and an unorganised group of co-workers have little in common, but you can clearly see what you need to do to weld people at work into a team.

Successful teams have certain features in common. They all have:

- Strong and effective leadership
- Clear objectives
- Appropriate resources

- The ability to communicate freely throughout the organisation
- The authority to act quickly on decisions
- A good balance of team members, with complementary skills and talents
- The ability to work collectively
- A size appropriate to the task

However talented the soloists are in a small business, in the end orchestras are what make enough noise to wake up slumbering customers and make them aware of your virtues as a supplier. But teams don't just happen. However neat the curricula vitae and however convincing the organisational chart, you can't just turn out a team-in-a-box. The presumption that people are naturally going to work together is usually a mistake. Chaos is more likely than teamwork.

Founding principles

Successful teams share common principles, outlined in the following list.

- **Balanced team roles:** Every team member must have a valuable team role. Experts in team behaviour such as R Meredith Belbin have identified the key team profiles that are essential if a team is to function well (you can find full details on Belbin's widely used team role evaluation system at www.belbin.com or by calling 01223 264975). Any one person may perform more than one of these roles. But if too many people are competing to perform one of the roles, or if one or more of these roles is neglected, the team is unbalanced. Its members then perform in much the same way as a car does when a cylinder misfires. The key roles that Belbin describes are:

- **Chairperson/team leader:** Stable, dominant, extrovert. Concentrates on objectives. Does not originate ideas. Focuses people on what they do best.
- **Plant:** Dominant, high IQ, introvert. A 'scatterer of seeds' who originates ideas. Misses out on detail. Thrusting but easily offended.
- **Resource investigator:** Stable, dominant, extrovert and sociable. Lots of contacts with the outside world. Strong on networks. Salesperson/diplomat/liaison officer. Not an original thinker.
- **Shaper:** Anxious, dominant, extrovert. Emotional and impulsive. Quick to challenge and to respond to a challenge. Unites ideas, objectives and possibilities. Competitive. Intolerant of woollyness and vagueness.
- **Company worker:** Stable, controlled. A practical organiser. Can be inflexible but likely to adapt to established systems. Not an innovator.
- **Monitor evaluator:** High IQ, stable, introvert. Goes in for measured analysis not innovation. Unambiguous and often lacking enthusiasm, but solid and dependable.
- **Team worker:** Stable, extrovert, but not really dominant. Much concerned with individuals'

needs. Builds on others' ideas. Cools things down when tempers fray.

- **Finisher:** Anxious introvert. Worries over what may go wrong. Permanent sense of urgency. Preoccupied with order. Concerned with 'following through'.

- **Shared vision and goal:** The team members must have ownership of their own measurable and clearly defined goals. This means involving the team in business planning. It also means keeping the communication channels open as the business grows. Those in the founding team knew clearly what they were trying to achieve and because they probably shared an office they shared information as they worked. But as the group gets larger and new people join, you have to help the informal communication systems work better. Briefing meetings, social events and bulletin boards are all ways to get teams together and keep them facing the right way.

- **Shared language:** To be a member of a business team people have to have a reasonable grasp of the language of business. Extolling people to improve return on capital employed or reduce debtor days isn't much use if they have only the haziest notion of what those terms mean, why they matter or how they can influence the business's results. So you need to develop rounded business skills across all the core team members through continuous training, development and coaching.

- **Compatible personalities:** Although having different team profiles is important, having a team who can get on with one another is equally vital. Team members have to be able to listen to and respect each other's ideas and views. They need to support and trust one another. They need to be able to accept conflict as a healthy reality and work through it to a successful outcome.

- **Good leadership:** First-class leadership is perhaps the most important characteristic that distinguishes winning teams from the also-rans. However good the constituent parts, without leadership a team rapidly disintegrates into a rabble bound by little but a pay cheque.

You can't just pick people and put them into teams because of their particular professional or job skills. If the team is to function effectively, its balance of behavioural styles has to mesh too.

Coaching and Training

Coaching and training are two ways to help individuals and teams improve their performance.

JARGON ALERT

A *coach* is a skilled and experienced person who watches an individual or small group performing a task. The coach shows them individually how they can improve their performance. The emphasis is on personalised instruction. *Training* is usually a more formal process, where the trainer has a set agenda for the event based on the knowledge required by the trainees. Everyone being trained goes through much the same process, at the same time.

Small firms are notoriously bad at recognising the need for training of any type. Over 40 per cent of small firms devote only one day or less to staff training each year. Only 13 per cent invest five days or more in training. Amateur football teams spend more time in training than the average small firm, so the fact that few teams in that firm ever realise their true potential, or come anywhere near becoming professionals, is hardly surprising.

And yet all the evidence is that training pays a handsome and quick return.

The choices a small firm has for training are:

- **On-the-job coaching:** This is where people learn from someone more experienced about how a job should be done. The advantages are that this kind of coaching is free and involves no time away from work. It should also directly relate to an individual's training needs. However, the coaching is only as good as the coach, and if the coach is untrained you may end up simply replicating poor working standards.
- **In-house classroom training:** This is the most traditional and familiar form of training. Some, or all, of your employees gather in a 'classroom', either on your premises or in a local hotel. You hire in a trainer or use one of your own experienced staff. This method provides plenty of opportunity for group interaction and the instructor can motivate the class and pay some attention to individual needs. The disadvantages, particularly if you hold the training away from your premises, are that you incur large costs that are more to do with hospitality than training, and for a small firm releasing a number of employees at the same time is time consuming and difficult.
- **Public courses:** These are less expensive than running a training programme in a hotel. You can also select different courses for different employees and so tailor the training more precisely to their needs. However,

most public courses are generic and the other attendees are more likely to come from big business or even the public sector, so much of what is covered may be of little direct relevance to your business. Quality can be patchy.

- **Interactive distance learning:** This kind of training can be delivered by a combination of traditional training materials, teleconferencing and the Internet and email discussions. You miss out on the personal contact, but the costs are much lower than traditional training. Most of the learning programmes are aimed at larger firms, so some material may not be so relevant.
- **Off-the-shelf training programmes:** These come in packaged kits, which may consist of a training manual, video and/or a CD-Rom. Once again, the cost is lower than for face-to-face training, but you miss out on a professional trainer's input.
- **College courses:** Many universities and business schools now offer programmes tailored to the needs of small firms. Professional instructors who understand the needs of small firms deliver these courses. They're relatively expensive, but can often be very effective.
- **Government initiatives:** Governments have an interest in encouraging training in small firms. As well as providing information on where their training schemes are being run, governments often provide training grants to help with the costs.

To make sure that you get the best out of your training, follow these guidelines.

- Introduce a routine that ensures that all employees attending training are briefed at least a week beforehand on what to expect and what you expect of them.

- Ensure that all employees discuss with you or their manager or supervisor what they got out of the training programme – in particular, did it meet both their expectations? This should take place no later than a week after the programme.
- You or the manager need to check within a month, and then again at regular intervals, to see whether their skills have improved, and that they're putting those skills into practice.

Evaluate the costs and financial benefits of your training and development plans, and use this information to help set next year's training budget.

You can find a training course or programme for yourself and anyone you employ from Business Link (go to www.businesslink.gov.uk, then click on Employment and skills followed by Find and fund training, How to find a Provider/Course.) The Massachusetts Institute of Technology (http://ocw.mit.edu/index.htm) makes virtually all its courses freely available on the World Wide Web for non-commercial use, as part of its long-standing objective to focus the contributions of both its faculty and its new technologies on broad, societal benefits.

Appraising Performance

Appraising the performance of both teams and individuals isn't primarily concerned with blame, reward or praise. Its purpose is to develop people and help them perform better and be able to achieve their career goals. The result of an appraisal is a personal development plan.

Appraisal lies at the heart of assessing, improving and developing people's performance for the future of the business. However, for it to be an effective tool, everyone involved needs to approach appraisal seriously and professionally. The appraisal has to be a discussion between people who work together rather than simply a boss dictating to a subordinate. It should be an open, two-way discussion for which both the appraiser and appraisee prepare in advance.

The ground rules for successful appraisals are:

- It should be results oriented. The appraisal interview starts with a review against objectives and finishes by setting objectives for the year to come.

  Set intermediate goals and objectives for new staff even if you can't realistically set final goals. For example, challenge new salespeople to acquire product knowledge and visit all the key customers, leaving actual sales achievement objectives until later in the year.

- The appraisal discussion should be separate from salary review. A discussion about salary is unlikely to encourage people to be open and frank, but an appraisal must be both those things. The salary review and the appraisal must be seen as different events and if possible carried out at different times of the year.

- The appraisal format is a narrative rather than consisting of tick boxes and ratings schedules. It covers a discussion of achievements, areas for improvement, overall performance, training and development, and career expectations.

Allow plenty of time for each appraisal interview (one and a half hours on average). The setting should be free from interruptions and unthreatening.

Carry out appraisals at least once a year, with more regular quarterly reviews – you should review new staff after three months. Some owner-managers question the necessity of a formal annual appraisal when they feel that they're already appraising their team informally on a day-to-day basis. That approach is rather like trying to assess a business by its daily trading figures rather than its annual profit and loss account. The changes in behaviour and performance you're trying to assess happen over a longer time span and may not be easy to see on a day-to-day basis. Also, your daily assessments are likely to be influenced by pressures and feelings on the day and may not reflect the true longer-term picture.

Use appraisals to identify training needs and incorporate any deficiencies into a personal or company-wide training plan.

EPIC Training and Consulting Services has a free Workforce Development Toolkit on its website, including a guide on carrying out appraisals and templates for both appraiser and appraisee (http://workforce.epicltd.com).

Developing a Leadership Style

Most large organisations have grown up according to basic management principles. If you started your business career working for a bigger firm, or your present managers worked in such enterprises, you know the scenario. Managers in these organisations plan, organise and control in a way that produces consistent if unexciting results. The formula worked remarkably well for much of the 20th century, when all a successful company had to do to prosper was more of the same. But management that's all about maintaining order and predictability is ill-equipped to deal with change, which is the order of the day in the 21st century. To cope with change effectively you need to be a leader as well as a competent manager – and young businesses are in greater need of leaders than they are of managers, at the outset at least.

Understanding leadership

Leadership and management aren't the same, although many businesspeople fail to make the distinction. The late management professor Peter Drucker summed up the difference between leaders and managers thus: 'A leader challenges the status quo; a manager accepts it.'

In a world where product lifecycles are shrinking, new technologies have an ever shorter shelf life and customers demand faster delivery and higher quality, the leader's job increasingly means defining and inspiring change within a company. By setting a company's direction, communicating this to its workforce, motivating employees and taking a long-range perspective, a leader adapts the firm to whatever volatile environment it does business in. In short, leaders become the change masters in their own firms.

Delegating

Overwork is a common complaint of those running their own business. They never have enough time to think or plan. But if you don't make time to plan you can never move forward.

Delegating some tasks eases the stress. *Delegation* is the art of getting things done your way by other people. Or as one entrepreneur succinctly put it, 'making other people happy to make you rich'.

Many owner-managers are unable to delegate, either because they draw comfort from sticking to routine tasks such as sending out invoices, rather than tackling new and unfamiliar ones such as keeping up on developments in the industry, or because they just don't know how to delegate. Either way, neither the business nor those in it can grow until delegation becomes the normal way to operate.

Delegating brings benefits to everyone involved in the process.

Benefits for the boss include:

- **More time to achieve more today and to plan for the future:** In this way you can free up time to tackle high-value-added tasks such as recruitment and selection, or motivation.
- **Back-up for emergencies and day-to-day tasks:** By delegating, you have a reserve of skilled people who can keep the business running profitably if you're not there. This can also give customers and financial backers the comfort of knowing that they aren't dealing with a one-person operation that would fall apart without you.

Benefits for employees include:

- **The opportunity to develop new skills:** Failing to delegate deprives employees of the opportunity to learn new skills and to grow themselves, and drives good employees, just the ones a growing organisation desperately needs, away in search of greater challenges.

Employees who have assumed the responsibility for new tasks train their staff in the same way. Then the organisation can grow and have in-depth management.

- **Greater involvement:** Research consistently shows that employees rank job satisfaction to be of equal or greater value than pay. Delegation encourages people to take ownership of their decisions and increases their enthusiasm and initiative for their work, so they get more satisfaction from their work.

Benefits for the business are:

- **Efficiency improves** by allowing those closest to the problems and issues being faced to take the decisions in a timely manner.
- **Flexibility of operations increases** because several people are able to perform key tasks. In this way you can rotate and expand or contract teams and tasks to meet changing circumstances. Delegation also results in more people being prepared for promotion.

Delegating successfully

Delegation is a management process that you shouldn't confuse with 'dumping', in which unpopular, difficult or tedious tasks are unceremoniously shoved onto the shoulders of the first person who comes to hand. To make delegation work successfully, adopt the following five-point plan.

1. **Decide what and what not to delegate.**

   The general questions for deciding what should be delegated are:

   - Can anyone else do or be trained to do the work to a satisfactory standard?

- Is all the information necessary to carry out the task available to the person(s) to whom you're planning to delegate the task?
- Is the task largely operational rather than strategic?
- Would delegating the task save you a reasonable amount of time?
- Would some initial teething problems while the new person settles into the task cause undue problems? Delegation itself is a form of risk taking, so if you can't deal with a few mistakes then delegation proves difficult.
- Can someone other than you properly exercise direct control over the task?

You can usually readily delegate any routine jobs, information gathering or assignments involving extensive detail or calculations. Tasks that are less easy to delegate include all confidential work, discipline, staff evaluation and complex or sensitive issues.

2. Decide to whom to delegate.

The factors to consider here are:

- Who has the necessary skills?
- Who could or should be groomed for future promotion?
- Who's most likely to respond well to the challenge?
- Who's most likely to be or continue to be a loyal employee?
- Whose workload allows her to take on the task(s)?

3. Communicate your decision.

Factors to consider here are:

- Discuss the task you propose to delegate one to one with the individual concerned.
- Confirm that she feels up to the task or agree any necessary training, back-up or extra resources.

- Set out clearly in writing the task broken down into its main components, the measurable outcomes, the timescales and any other important factors.
- Allow time for the implications to sink in and then discuss with the person concerned how she proposes going about the task.
- Let others in the business know of your decision.

4. **Manage and evaluate.**

   From the beginning, clearly establish set times to meet with the person delegated to and review her performance. Make the intervals between these reviews short at first, lengthening the period when the person's performance is satisfactory. The secret of successful delegation is to follow up.

5. **Reward results.**

   Things that get measured get done and those that are rewarded get done over again. The reward need not be financial. Recognition or praise for a job well done are often more valuable to an ambitious person than money.

Evolving leadership styles for growth

All businesses require leadership, but they don't require the same type or amount of leadership all the time. As with children, businesses don't grow seamlessly from being babies to adulthood. They pass through phases – infancy, adolescence, teenage years and so on. Businesses also move through phases if they're to grow successfully. Each of these phases is punctuated by a *crisis*, used in this sense to signify a dangerous opportunity.

Researchers have identified several distinctive phases in a firm's growth pattern, which provide an insight into the changes in organisational structure, strategy and behaviour that you need to move successfully on to the next phase of growth. The inability to recognise the phases of growth and to manage the transition through them is probably the single most important reason for most owner-managed firms failing to achieve their true potential, let alone their founder's dreams.

Typically, a business starts out taking on any customers it can get, operating informally, with little management and few controls. The founder, who usually provides all the ideas, brings all the drive, makes all the decisions and signs the cheques, becomes overloaded with administrative detail and operational problems. Unless the founder can change the organisational structure, any further growth leaves the business more vulnerable. The crises of leadership, autonomy and control loom large.

Over time, the successful owner-manager tackles these crises and finds a clear focus, builds a first-class team, delegates key tasks, appraises performance, institutes control and reporting systems, and ensures that progress towards objectives is monitored and rewarded. The firm itself consistently delivers good results. There's no set time that each of these phases should last. A firm may take anything from three to ten years to reach the third phase of growth.

Each phase of growth calls for a different approach to leading the business. At times strong leadership is required; at others a more consultative approach is appropriate. Some phases call for more systems and procedures, some for more cooperation between staff. Unfortunately, as the business gets bigger most founders try to run their business in much the same way as they did when it was small. They end up with a big small company, rather than the small big company that they require if they're to achieve successful growth. They believe that taking on another salesperson, a few hundred square metres of space or another bank loan can solve the problems of growth. This approach is rather like suggesting that the transition from infancy to adulthood can be accomplished by nothing more significant than providing larger clothes.

Managing change

The late professor Peter Drucker claimed that the first task of a leader is to define the company's mission. In a world in which product and service lifecycles are shrinking, new technologies have ever shorter shelf lives and customers demand ever higher levels of both quality and innovation. Entrepreneurial leadership means inspiring change.

Being flexible enough to change

In adapting the business to an increasingly volatile and competitive environment, the boss must become the change master in the firm. Small firms are usually better at handling change than big firms. A speedboat can always alter course faster than a supertanker. However, small firms often have to adapt to much more change than big established firms. Big firms usually define the standards in an industry and the small firms have to scramble to keep up.

The turbulence created by changes in the economy can also create a wash that can sink small firms unless they can adapt and change quickly. Those small firms most able to adapt and change, and of course those who are most prepared, are most likely to survive and prosper during turbulent times.

But recognising the need for change falls a long way short of being able to implement it successfully. Few people like change and even fewer can adapt to new circumstances quickly and without missing a heartbeat.

By definition, a small business seeking growth must be able to manage a fast rate of change. Entrepreneurs must see change as the norm and not as a temporary and unexpected disruption that goes away when conditions improve.

Planning for change

Change management is a business process, like any other business process. Following a tried and proven procedure can improve your chances of getting it right more often.

These four steps show how you can break down change management into its elements.

1. **Tell staff why change is necessary (or better still, help them to find out for themselves).**

   The benefits of change aren't always obvious. So spell them out in much the same way as you explain the benefits of your product or service to a prospective customer.

   Explaining the background to the changes you want to make helps people see the changes as an opportunity to be competitive rather than a threat to existing work practices.

   Better than just explaining is to encourage staff to look outside the business for themselves, identify potential problems and suggest their own solutions. Not only may they have great ideas for change – perhaps better than yours – but they may be more willing to take responsibility for making the changes succeed.

2. **Make the change manageable.**

   Even when people are dissatisfied with the present position and know exactly what needs to be done to improve things, the change may still not happen. The change may be just too big for anyone to handle. But if you break the change down into manageable bits, you can make it happen.

3. Take a shared approach.

Involve people early on. Asking them to join you in managing change only at the implementation stage is too late to get their full cooperation. Give your key participants some say in shaping the change right from the start. This means that nobody feels that you're imposing the change and more brains are brought to bear on the problem.

Individual resistance to change is a normal reaction. By understanding why people are resisting you can help them overcome their doubts and embrace the change. Try to anticipate the impact of the change on the people involved:

- Get an overview of the forces at work, both in favour of and against the change.
- Make a list of those most affected by the change. Put each person into one of four categories – no commitment; will let it happen if others want it; will help it happen; will make it happen.

  Examine how each person is likely to be affected by the change. Look at career prospects, working hours and conditions, team membership and so forth.
- Anticipate retraining. Often a fear of failing is the principal reason for people not trying something new.

Open, face-to-face communication is the backbone of successful change. It gets across the 'why' of change and allows people to face up to problems openly. It also builds confidence and clears up misunderstandings.

Open communication is vital, but announcing intended changes before you have some committed participants alongside you is risky.

4. Reinforce individual and team identity.

People are more willing to accept change and to move from the known to the unknown if they have confidence in themselves and their boss. Confidence is most likely to exist where people have a high degree of self-esteem. Building up self-esteem involves laying stress on the positive rather than the negative aspects of each person's contribution. Exhortations such as 'you guys have had it too easy for too long' are unlikely to do much for people when you're faced with major competitive pressure.

You need to emphasise the importance to the change project of each person, both as an individual and, where appropriate, as a team member. A positive, confident climate for change needs lots of reinforcement, such as the following ideas:

- Reward achievement of new goals and achieving them quickly.
- Highlight success stories and create as many winners as possible.
- Hold social events to celebrate milestones.
- Pay personal attention to those most affected by the change.

Change takes longer than you think. Most major changes make things worse before they make them better. More often than not, the immediate impact of change is a decrease in productivity, as people struggle to cope with new ways of working while they move up their own learning curve.

The doubters can gloat and even the change champions may waver. But the greatest danger now is pulling the plug on the plan and either adopting a new plan or reverting to the status quo.

To prevent this 'disappointment', you have to set realistic goals for the change period and anticipate and plan how to handle the time lag between change and results.

Measuring Morale

How your employees feel about their jobs, their co-workers, the company and you and other bosses has a direct effect on how well or poorly they do their jobs. You need to stay on top of morale issues to keep your business running smoothly.

The most reliable way to measure morale at work is to carry out an attitude survey. In a big company, one-to-one interviews and focus groups may accompany such surveys. But in a small firm that's not really an option.

In much the same way as you may survey customers to find out how happy they are with your products and services, survey your employees to find out what they feel about their employment conditions. Attitude surveys provide an objective measure to counterbalance the more descriptive view that you can obtain from discussions and gossip. They also provide a useful way to see whether morale is getting better or worse over time.

You may decide to introduce attitude surveys because of a particular event, such as a number of key staff leaving at the same time or some other obvious problem. Change can upset morale and that can have a knock-on effect on business performance. But after you've started, keeping the practice up makes sense. At the very least surveying your employees demonstrates your concern, and at the best it gives you valuable pointers to raising morale, output and profits.

A word of warning: your attitude surveys are inevitably going to reveal two basic facts. The first is that everyone believes that they're underpaid. The second is that everyone believes that communication is awful. Both these feelings are fairly normal and you can at least draw comfort from that.

Most people believe that they're underpaid both by market standards and in relation to the effort they put in. They also believe that the gap between levels in the company is too great. This belief that they're poorly rewarded exists irrespective of how much people are actually paid, or indeed how hard they work. If you ask them why they don't leave, they tell you about loyalty to a small firm or perhaps, more flatteringly, loyalty to you.

Nearly all employees also believe that their boss knows a secret that directly affects them that the boss isn't willing to divulge. This may be about restructuring, moving, merging or outsourcing. This phenomenon happens at all levels. The shop floor believes that supervisors have secrets; supervisors believe that managers withhold crucial information on plans that involve them; and the remaining managers know that the directors are planning their future in secret. So they become convinced that a communication problem exists in the organisation because no one tells them what is *really* going on.

You have to take all the information from your employees into consideration when sizing up the situation, and not just the results of one attitude survey.

HR-Survey (www.hr-survey.com) and Custom Insight (www.custominsight.com) provide fast, simple and easy-to-use software to carry out and analyse human resources surveys. They both have a range of sample surveys that you can see and try before you buy, which may just be enough to stimulate your thinking.

Introducing attitude surveys

John Huggett, a young and abrasive entrepreneur, moved south from Yorkshire and bought up a small but seriously troubled engineering factory. The company employed 22 people and had shrunk over the years from more than 50. The business had suffered losses for over a year. But Huggett succeeded brilliantly in solving the problems that had built up over the years.

In the process, by his own admission, he came close to committing murder – telephone directories and occasionally the telephone itself flew through the air. Those in the organisation perceived John – not unnaturally given his style and the rescue job he was attempting – as a fire-eating monster. No one saw the human behind the gruff exterior.

At that time this didn't matter. However, as the factory moved into a period of growth and expansion, John recognised that he and the management team needed to make a conscious effort to change towards a more consensual style of management. People didn't feel empowered and they weren't about to stick their necks out when the blood still ran from the walls. John stood up in front of the workforce and said, 'We're going to have a different management style, and we're going to change.' He introduced an attitude survey to take the temperature of the water and committed himself, in advance of the survey, to live by its results.

He and the management team have done just that, introducing exceptionally effective team briefings, management walkabouts and other consultative mechanisms. The work force took time to be convinced, but they came greatly to respect John's integrity and open style.

Part V
The Part of Tens

'My friends on the dock helped me with the slogan.'

In this part . . .

You probably have a file somewhere marked 'Miscellaneous', which contains all the information you know you're going to find really useful one day. You can think of this part as a collection of tips, cautions, and suggestions that will help you start up and grow your business, or move on when the time is right. Read on!

Chapter 19

Ten Pitfalls to Avoid

In This Chapter

- Making sure that you have the right skill base
- Keeping track of key financial data
- Staying out of the failure statistics

Difficult times, such as those that occurred 2008–2010, can cause even the biggest and apparently most established firms to hit the buffers. After all, Lehman Brothers survived the 1929 depression and Woolworths had put in some time on almost every high street in the UK, yet both were swept away in the recent downturn.

Some 400,000 small businesses close down each year in the UK and over half of those closures occur in the first year of trading. Although not all the closures come under the heading of home-busting events, no one likes to have a personal failure on their hands, even if it doesn't wipe them out financially.

This chapter lists the main problems that cripple most small businesses that have to shut their doors in the first year or so.

Knowing Too Little

Running your own business calls for a well-rounded range of expertise. In the early morning you may have to be coach and trainer to a new employee, by mid-morning – coffee-break time in big business parlance – you can be negotiating with the bank for an extra line of credit, at midday you may be drafting a marketing strategy and the early afternoon can involve looking for suppliers for a new product you're thinking of launching. The late afternoon may find you delivering a rush order to a key customer, followed by a quick shifty around a competitor's premises and a couple of possible premises for you to move into if you grow as planned. The evening is devoted to drafting a job advertisement and a leaflet, leaving the weekend to get the books up to date and the VAT return done.

Take time out before you start your business to brush up on the range of skills you're going to need. More opportunities now exist than ever before for education and training, at every level, in the small business and management field. You don't require any formal academic qualifications for most of the courses and costs are generally modest. In certain cases, participants may be eligible for grants or subsidised training. The bulk of the activities are concentrated in universities and colleges throughout the UK.

Find a course for yourself or employees through these websites:

- The Skills Funding Agency (http://skillsfundingagency.bis.gov.uk) has a mission to ensure that people and businesses can access the skills training they need to succeed in playing their part in society and in growing the economy. The website includes advice on selecting a training programme and a directory of training providers using their impartial Skills Brokerage service. They aim to help employers and employees identify the best value for money, which may mean finding training that is partially or wholly funded by the Government.

- The Learning Directory (www.learndirect-advice.co.uk/providers) is the Government-funded national database of learning opportunities containing information on approximately 900,000 courses from more than 10,000 providers in the UK.

However, a growing number of opportunities are arising for the less mobile to take up some form of home study in the business field in general, and small-business opportunities in particular. With the growth of the Internet, British entrepreneurs may now find it practical and worthwhile to get their learning experience from virtually any part of the world (see Chapter 18).

Being Overly Optimistic about the Market

Business starters are, by nature, optimistic. You have to be to overcome the hurdles, both natural and man-made, that appear in your path. But the one area you can't afford to be over-optimistic about is the market itself. That's the one thing you can't change. You can replace people, you can improve products and you can find money or new premises. But the raw ingredient of any business, the potential market, is a given that you can't easily change. True, big businesses talk grandly about educating the market to appreciate their wonderful product or service, but educating markets calls for deep wallets and long time horizons, both in short supply in the small-business world.

WARNING!

Take care not to develop the 'iceberg syndrome'. Don't believe that the small number of customers you can see is a sure indication of the great mass of other customers lying hidden below the water-line just waiting for you to sell to them. Believing that customers are simply waiting to be sold to and that competitors are either blind or lazy is a fundamental mistake.

Underestimating Start-up Time

Everything in business seems to take longer than you think. Premises take ages to find and even longer to kit out and be ready for use. If you start up before you're ready, customers may well be disappointed and rush around sharing their displeasure.

Make a chart showing the key tasks that you have to carry out before you can start up your business in the left-hand column, with the timescale in days, weeks or months, as appropriate to your business, across the top of the chart. In the right-hand column show who's responsible for each task.

Draw a bar between the start and finish date for each key task, showing how long the task should take. Some of the tasks will overlap others and some will depend on the successful completion of earlier tasks. For example, you can't install the oven in a restaurant until you've found the premises and signed the lease. You can, however, research oven suppliers and negotiate the price and delivery. Use the chart to monitor progress and take corrective action as you go.

Spending Too Much at the Start

New businesses should be lean and mean. Don't spend too much on fixtures, fittings and equipment too soon. People with a background in big business often start with extravagantly high standards. They expect the latest computer equipment, broadband Internet access, colour photocopier and cappuccino maker close to hand, and to sit in an executive-style office from the outset. You have to spread these overheads across the products/services that you sell and you can lose your competitive edge by being too expensive. See Chapter 8 for information on start-up costs.

Mistaking Cash for Profit

The cash that flows into the business hasn't had any of the automatic deductions knocked off it, as has a pay cheque from an employer. So the money that comes in is *gross* cash flow. It may be real cash, but it's not really yours, or at least not all of it is yours. You may be tempted to use this cash to maintain your living standards, but don't yield to it. When the bills come in – from the suppliers, for National Insurance, for VAT – as they inevitably do, you may be stuck for the cash to pay them. Her Majesty's Revenue and Customs puts more businesses into liquidation than anyone else.

Maintain a cash-flow forecast on a rolling quarterly basis. In that way you always have a one-year view of what's likely to happen to the cash in the business. Use the cash-flow projection to anticipate peaks and troughs in your cash flow.

Use a spreadsheet and either write the program yourself or use the template that comes with your accounting software. Manual cash-flow systems are inefficient and discourage regular updates. On the other hand, spreadsheet updates are simple, efficient and free of arithmetical errors, at least.

Choosing the Wrong Partner

A partnership is to business life what a marriage is to the rest of your life – a long-term, all-pervading relationship that spills over into and affects everything you do. Partnerships are complicated affairs, relying as much on chemistry as on personal attributes, skills or knowledge. Just as you should never embark on a marriage without a few months of dating at the very least, you should find a way to test out a partnership before you formalise the relationship. (See Chapter 5 for the legal aspects of partnerships.)

Take on a project together that involves using the skills and expertise you hope your prospective partner brings to the business. If you want the person to do the buying, for example, go to a trade show together, preferably one that involves a couple of days' travelling to and from the venue. Watch her at work talking to exhibitors and opening up negotiations. Get her to meet others involved with your business – your spouse, bank manager, key clients; in fact, anyone who knows you well – and get their reaction.

The big factor to keep in mind is that a business partnership is likely to last longer than the average marriage. So if you can't face that, don't start a partnership.

You might be forgiven for thinking that Simon Nixon, the founder of Moneysupermarket.com, a European financial services price comparison website, has everything to be pleased about. Ranked in the top ten companies with the fastest profit growth in the *Sunday Times*/PricewaterhouseCoopers Profit Track 100 within seven years of starting up, the company generated annual profits of £23.4 million . It has successfully spread its price-comparison skills launching Travelsupermarket.com and sites to compare utilities, the Internet, insurance, mobile phones and motor cars. But all isn't rosy in Nixon's garden. His considerable expertise is in the mortgage business, and in order to get access to the IT skills he needed to get the business launched he engaged IT expert Duncan Cameron on a 50/50 basis. Cameron, the brother of Nixon's former girlfriend, hasn't been in contact with Nixon for years and is treated as a silent partner. However, Cameron's substantial holding means that he could at any stage demand a place on the board, sway strategy or, more worryingly, block moves to float the company on the stock market.

Ignoring Accounting

Many owner-managers see accounting as a bureaucratic waste of time that they only carry out to keep the tax authorities off their backs and make it easier for those authorities to carve a deeper trough in their hard-won profits. Although you can have some sympathy with that point of view, you can't condone it. For too many new businesses their first year's accounts are also their last. By the time they really know what's going on it may be too late to put things right.

Forgetting Working Capital

Most business starters can work out how much the big-ticket items cost – computers, vehicles and office furniture, for example. But they often forget to allow for the recurring items such as money owed by customers, stock in trade and 'invisible' items such as insurance. To make matters more complicated, these items often have time lags associated with them. A customer who owes you money has to be financed until she pays up, as do your raw materials until you can turn them into saleable product that's been delivered and paid for. These items constitute a business's working capital (Chapter 14 talks about working capital), and the more successful you are, the more of a problem working capital becomes.

Think about it. The first thing that happens when you get a new big order is you need the ingredients or raw materials to put it together. Your suppliers expect payment within 30 days, or perhaps even on a pro forma basis (cash with delivery) in your early months of trading. But the snag is that you have to work up your product using bought-in raw materials, which may take weeks or months, and then wait for months for payment. In the meantime you're hung out to dry with a growing need for working capital. The paradox is that nearly as many businesses go bust with the sales curve going up as with it going down. The technical term for this is *over-trading* and the cure is to allow for it in your business plans and make sure that you have sufficient working capital in place to survive.

Having No Clear Competitive Advantage

You or your product or service has to have something unique about it that makes you stand out from your competitors. It may be something as obvious as being open later or longer. Or it may be a policy such as the John Lewis Partnership's 'never knowingly undersold' message. Whatever your unique selling proposition is, communicate it effectively.

Choosing the Wrong Location

Where you conduct your business and how much rent you pay are vital factors. Don't be tempted to take premises just because the rent is cheap – a reason usually exists for this, such as few customers passing that route or poor transport links, making the premises difficult for employees and suppliers to get to.

Equally, don't take on an expensive town-centre site if your turnover is unlikely to cover your outgoings. Your market research (see Chapter 4 for more on this) should help you identify a suitable location.

Chapter 20

Ten People to Talk to Before You Start

In This Chapter

- Identifying all the key people who can help you get started
- Leveraging your network of contacts to maximum advantage
- Taking advantage of free advice
- Getting the lowdown on what people really think are your strengths and weaknesses

Starting up a business can be a lonely endeavour, but you don't have to do it all on your own. Hundreds of people, some just a few feet away, can give you useful insights into your skills and attributes, and they may even have a useful perspective on the viability of your business idea.

Speaking with Your Spouse

Your spouse may not know a great deal about your great business idea, but you can be sure she knows a lot about you. Your spouse can remind you of your weaknesses and help you play to your strengths. She also needs to be prepared for the long hours and lack of holidays that are sure to feature in the early months and years as you get your business established. This may mean that you need to re-divide the existing sharing of household and family tasks, such as taking children to school, family visits and painting and decorating, to reflect the new balance of work. That may prove contentious, so talking the issues through at the outset may save conflict and arguments when time constraints really start to bite.

The money put into the business is going to have an impact on the money available for other areas of family expenditure, so your spouse also has to be comfortable with the financial commitments you're taking on. Unlike most other investments you may have made – on houses and cars, for example – you can lose all the money you put into a business irrevocably.

One would-be entrepreneur who set out to open a bookshop was reminded by her partner how she disliked dealing with the general public. She loved books and delighted in visiting book fairs and auctions. But when reminded that essentially the job entailed opening and closing a shop six days a week, her enthusiasm level took a dive. Better take a dive before you start up than have your cash take a dive a few weeks afterwards.

If you're thinking of taking up some franchises – Chemical Express (www.chemicalexpress.co.uk), for example – then you may be asked to bring your partner along to the initial interview even if she's not going to be involved in the running of the business. Chemical Express wants to make sure that your partner is backing you 100 per cent, both practically and emotionally.

Making Use of Your Professional Network

The people in your network of associates have large chunks of the knowledge you need to get your business successfully launched. The ability to create and maintain strong professional relationships is an important key to business success. Networking is a vital business skill that lets you cultivate lasting business relationships and create a large sphere of influence from which you can find new clients, contacts, referrals and opportunities.

You can use a network for just about anything, from finding a new supplier to getting introductions to overseas sales agents. You can find a reliable bank manager, a new accounting software package or a great venue for your next business meeting. Your network contacts, unlike almost everyone else in the business world, are usually unbiased and authoritative. You should make few major decisions without recourse to network contacts.

Benefiting from Entrepreneurs Who Started a Similar Business

People like nothing more than talking about themselves and their successes. Obviously, if someone thinks you're going to steal her customers, she shuts up like a clam. But if the business you plan to start is unlikely to infringe on their sphere of activities, most established entrepreneurs are only too happy to pass on some of their hard-earned tips.

First establish that you're not going to tread on the entrepreneur's toes. For example, if you plan to start up in the same line of business 30 miles away, you have little chance of causing each other much trouble. You may even be able to open a shop at the far end of the same town as a competitor without doing the entrepreneur any serious damage.

Use your common sense as to whom to approach and, to be on the safe side, double the distance that you feel is a safe gap between you.

You may also find someone who's had a business failure in the field you plan to start up in and is prepared to talk. You can find such people by scouring the press or talking to trade associations and other operators in your sector.

Don't take everything entrepreneurs say, even the most successful ones, as inevitably right. The five businesspeople who comprise the dragons in the BBC programme *Dragon's Den*, with a combined personal wealth nearing £1 billion, can reasonably be expected to know a thing or two about new business ideas. Andrew Gordon presented to them his invention for propping up wobbly table legs and they unreservedly gave it the thumbs down. Despite being ripped to shreds as a concept, his stabletable (www.stabletable.co.uk), eight plastic leaves pinned together, has sold in industrial volumes on the Internet. The device earned the 34-year-old in excess of £500,000 in his first year and is now being sold in packs of 25 for use in restaurants, hotels, pubs and cafes throughout the world. Andrew is an inspiration to all would-be business starters whose ideas receive a less than rapturous reception from fellow entrepreneurs.

Events can be a valuable route to extending your business network. Useful organisations include the following:

- The Glasshouse (http://theglasshouse.net), founded in 1998, holds networking events bringing entrepreneurs, financiers and business advisers across all sectors together to provide support, encouragement and inspiration to would-be business starters.

- The Junior Chamber International United Kingdom (www.jciuk.org.uk) is a personal development and networking organisation for the under-40s. It's part of the global Junior Chamber International (JCI), which has over 250,000 members in 100 different countries.
- Networking4business (www.networking4business.com) organises business-to-business networking events that enable you to meet many other businesspeople without any commitment and in a relaxed, informal atmosphere.

Spending Time with a Friendly Banker

Despite having had a bad press during the credit crunch, these guys and girls have a lot to offer other than oodles of cash (or not!). Bankers see a lot of different people about a lot of different businesses. You can draw on their wide range of knowledge and experience. Your banker may be familiar with your type of business or the location you're interested in, or have advice on different financing options.

Start by talking with a bank manager you don't want to borrow money from. Begin the conversation by asking for advice, rather than money. Only when you've convinced yourself that your proposition is an appropriate one for a bank should you make a pitch. (See Chapter 8 for more about banks and bank managers.)

Tapping into Your Local Enterprise Agency Director

Over 1,000 business experts are sitting in a local office somewhere near you just waiting to offer advice, help, encouragement and support to anyone thinking about starting a business. The even better news is that the services they provide are either free or low cost. Enterprise Agencies (see Chapter 7) have been around for 25 years and are an initiative started by big business to help small business.

Bank managers, business executives on loan as part of their career development and the occasional civil servant, accountant and lawyer staff these agencies. Make sure that you grab your fair share of this expertise.

Communicating with Your Current Boss

Talking to your boss about anything other than the job in hand is always a tricky decision. Talk about your entrepreneurial vision too soon and you may find yourself sidetracked for promotion and pay rises and perhaps even first in line for the next downsizing event. Leave it too late and your boss may see your action as disloyalty at best and betrayal at worst.

If you plan to start up in the same line of work and possibly even try to take some key accounts with you, then you'd better talk to a lawyer rather than your boss. But if the climate is right and you can talk to your boss, a number of valuable things may happen. You boss can be a source of investment capital, a business partner or a useful resource for business advice and contacts.

Your boss may even become your first customer, if the businesses are compatible.

Calling Your Colleagues

Those you've worked alongside over the years have formed a view about your talents. Your spouse has seen you after work, but they've seen you at work. If they don't know your strengths, weaknesses, foibles and desires, then no one does. At worst they may tell you that you're barmy and explain why; at best they may join you in the venture or invest their hard-earned savings in your business.

If you were thinking about taking on a partner, then casting your eye around your colleagues is a good place to start looking. Remember, it cuts both ways. Although they may know a lot about how you perform at work, you know as much about them.

Bringing in Your Best Friend

On the assumption that your best friend isn't your spouse, then she represents someone else who should be able to tell you whether you're the right sort of person to start up the particular business you have in mind. You can start out by asking your friend to review your skills and knowledge inventory (see Chapter 3) and so provide a valuable crosscheck on your self-assessment. In fact, you should always find someone who knows you really well to go through this and the business idea-evaluation process (also in Chapter 3).

Unfortunately, everyone's capacity for self-deception is unlimited, and you shouldn't miss any opportunity for a reality check.

Reporting to an Accountant

You need an accountant in any event (I explain the process of finding one in Chapter 14). However, don't miss out on making the maximum use of as many accountants as possible when researching to establish your business. Take all the free advice you can get, because most accountants give you a free first meeting in the hope of signing you up as a client.

Pump the accountants as much as you can for any tips, pointers or advice on the business you have in mind.

- Accountants are the first port of call for any entrepreneur seeking help and advice, ahead of bank managers, small firm advisers and business associates. As a consequence, they're the repositories of an enormous amount of information on every aspect of business, not just finance.
- Accountants draw an increasing amount of their revenue from non-accounting tasks, and some even make more money from providing general business advice than they do from auditing.
- Most accountants are sole traders or in small partnerships operating in much the same way as you plan to do when you set up your business. So unlike bank managers, who all work in large organisations, accountants can identify with your problems and concerns.

Talk to the Added Value Network (website: www.avn.co.uk; tel: 0845 226 2371), a network of over 5,000 accountants working in over 400 offices across the United Kingdom who are focused on helping entrepreneurs start up and grow their businesses. It offers a free ‘Business Builder Review’ tailored to suit your needs but based on its experiences in helping 115,000 owner-managed businesses.

Plugging into a Business Angel Network

Business angels (see Chapter 8) have some attractive attributes. They aren’t as risk averse as venture capital firms; they act more quickly, putting up money in weeks rather than months; and they aren’t so fussy about your pedigree. But when it comes to giving a helping hand, they’re absolute stars. Using the business angel networks outlined in Chapter 8 you can find an angel with expertise in the sector in which you have an interest.

Chapter 21

Ten Ways to Cut Costs

In This Chapter

- Getting costs heading south, permanently
- Using your team to help save money
- Saving cash by saving the plant

People often see cost cutting as a one-off task, usually in response to some external crisis. The Credit Crunch of 2008–10 is a good example of when almost every type of organisation had costs squeezed hard. Google Insights noted that the use of the term *cost cutting* in web searches quadrupled between December 2006 and October 2010.

Companies consider nothing sacred in a downturn and will sacrifice almost anything to ensure corporate survival. The people usually charged with doing the squeezing are the chief executive officer (CEO), who sets the target, and the chief financial officer (CFO; accountant to you and me), who decides whose pips will be squeezed the hardest. At best the company assembles a task force to carry out the work, but usually the role of Mr Nasty is left to the CFO. After the crisis has passed everyone breathes a sigh of relief and gets back to business as usual, which usually involves spending more.

Cost cutting, however, is a permanent management process, and by concentrating its execution only during periods of distress or economic downturn a business can miss out on some major opportunities to pay less for more. Cost cutting also plays a vital role in ensuring a business becomes or remains competitive, an argument that I expand on in Chapter 1. Staying competitive means that fewer reasons exist for a knee-jerk reaction when the going gets tough.These are some practical ways to get you business on the right track to keeping costs heading south from day one onwards.

Using a Suggestion Scheme

Employees on the front line of your business are usually the first to spot where unnecessary money is being spent. Tapping into their knowledge will provide a rich seam of ways to cut costs and that's where a suggestion scheme comes in useful.

Founded in 1987, ideasUK is a not-for-profit, association in the UK dedicated to the development of efficient and effective staff suggestion schemes. Their thousand or so members and award-winners include companies and organisations of all shapes and sizes but including big names too, such as Boots, Bupa, Center Parcs, the Charity Commission, Diageo, Emirates Airline, GlaxoSmithKline and the Ministry of Defence.

To get the best out of a suggestion scheme follow these basic guidelines:

- Carefully plan new suggestion schemes and provided them with the resources and management backing to sustain them over the long term. A lot of dead schemes exist and they die very quickly if they aren't properly run.
- Suggestion schemes require constant promotion. Memories are short and as soon as you stop talking about the scheme suggestions dry up.

- Make the scheme fun. Schemes can be enlivened with short-term campaigns aimed at encouraging suggestions in areas such as energy-saving, the environment or low cost customer care. League tables, a lucky dip from a tub of accumulated suggestions or a boss's prize for the best of the year can all sustain interest.
- Handle suggestions quickly and efficiently. If employees have an idea and get excited they shouldn't be kept waiting more than 24 hours for an acknowledgement and you should come up with a response to the suggestion within a week.
- Reward suggestions, usually by giving a little and often. On average, schemes pay out about a fifth of the savings. See Chapter 11 for some ideas on motivating and rewarding your cost cutters.

Forming Smart Circles

One entrepreneur who'd built his company to a £3 million business from a standing start five years earlier formed his 20 employees into what he called *smart circles*. He challenged his employees to find ways the firm could do things faster, better and at a lower cost. In year one he doubled profits and within five years his business was valued at £10 million.

TIP

The key to success with such initiatives is to build the teams across functions, keep them small and set some work time and space for them to meet. Keep formalities to the minimum, but insist on a team leader being appointed and brief reports prepared. Change the team composition several times a year and publicise successes.

High performing teams don’t get formed by accident. Read up in Chapter 18 on building great teams.

Going Green

Over the past decade the business community has experienced what amounts to a green revolution. Pressures on business to produce less waste, use less energy, consume less water, encourage employees to walk, cycle or to work from home for at least part of the time abound. That this green wave has received the enthusiastic support of business is in large measure because many of these activities are consistent with aggressive long-term cost cutting. The beauty, from a business perspective, is that this pressure to go green comes from outside and is supported in many cases by legislation. Companies such as 3M, DuPont, IBM and latterly Google, Cisco and Microsoft are enthusiastic green cost cutters and have saved billions. Toyota, with innovative hybrids such as the Prius, has created what amounts to new streams of revenue while greatly enhancing the value of its brand.

The evidence is that employees like working for green businesses. A global study by Hill & Knowlton, the corporate communications firm, revealed that four in every ten MBA students wouldn’t take ‘a great offer’ from a company with a poor environmental reputation. Another survey covering college students found that 92 per cent want to work for a green company.

Under the Climate Change Act, the government must introduce carbon reporting across all businesses by 2012 (unless, of course, they change their mind!). So it’s worth getting to grips with your business's carbon footprint. An easy move is to get greener vehicles. Low-emission vehicles cost less to tax and insure, are fuel efficient and attract fast tax write-down rates, in some cases as much as 100 per cent of the purchase price in the first year. Also look at GreenWise (www.greenwisebusiness.co.uk), an independent daily information service for businesses – large and small – that want to learn more about the opportunities and challenges of moving to a low carbon economy.

And if you're thinking of basing your business on a green product or service, check out the Carbon Trust's Entrepreneurs Fast Track service (www.carbontrust.co.uk/fast-track), which helps early-stage companies make the transition from low carbon concepts to commercialisation. Often such ventures are high-risk in nature and find it difficult to attract finance and managerial talent. As well as expert advice and networking opportunities the Fast Track service channels £5 million a year into clean tech ventures with the highest growth potential.

Using Less Utilities

Every business needs heat, light, water, power and communications systems. The question really is: are you wasting energy, and therefore money? 1E, a software solutions provider, calculated that it would be possible to save over £1.69 billion in the US just by turning off business PCs when not in use. The UK and Germany could save £300 million and £800 million respectively in this way. 1E estimated that if the world's 1 billion PCs were powered down for just one night, it would save enough energy to light up New York city's Empire State Building – inside and out – for over 30 years.

Here are some tips to cut down your utility bills and save energy:

- **Turn down the thermostat.** According to the Carbon Trust turning heating down by just 1 degree can cut costs by upwards of 8 per cent. Keeping doors and windows closed when heating or air conditioning is on and avoiding simultaneously heating and cooling at the same time can increase such savings further. Bear in mind that rules govern the required temperature of business premises.
- **Lower lighting.** Making use of natural lighting by selective position of work positions can reduce lighting costs by up to 19 per cent. Using individual lights rather than lighting an entire work area and using energy-saving light bulbs can help too.
- **Switch off unused appliances.** Encourage staff to switch off devices and lights when not in use. You can save around £29 a year just by turning off a single PC when not in use. You can stimulate interest by measuring exactly how much power individual devices use – computers, printers, faxes and so on – or by user. It costs as little as £12 to get a unit to track the power used by a single plug. Put shared equipment like faxes, water coolers, printers and vending machines on a seven -day timer. The payback period can be as little as a few weeks and thereafter you can make significant cost savings.

Talk through energy-saving issues with your employees, making sure they understand why you're making any changes – to save the planet and not just the boss's pounds.

Stripping Out Waste

The challenge is to strip out waste or find ways to step up yield. If you're working on your own this probably won't be a fertile field, but after you have employees, however dedicated, the problems start.

The food industry is perhaps the most visible industry with a waste problem. From farm to plate some 20 million tons of food are wasted every year in the UK, and businesses are directly responsible for around a third of that waste. But nearly every industry produces waste and that has cost implications both for production efficiencies, disposal and the firm's capacity to meet an ever-increasing array of environmental challenges and regulations.

You can contact Envirowise (http://envirowise.wrap.org.uk) a UK government-sponsored body that acts as a one-stop shop for advice on resource efficiency, for help in finding out how to strip waste in your business. The nearby sidebar 'Turning waste into cash' shows how Envirowise's advice helped one business.

These are a few other ideas for cutting back on waste:

- Most businesses when making copies use only one side of the paper for printing on, so one whole side is effectively wasted. Microsoft (http://office.microsoft.com/en-us `> Support >Word > Printing > Print Options`) provide advice on how to get your printer to operate in duplex mode, as copying on both sides is known.

- Time is something everyone uses and almost invariably uses too much of. Start by keeping a diary tracking exactly how you and your employees spend their time broken down by activity. Then see how that measures up against the relative importance of each task. So if you are spending most of your time answering routine customer queries rather than selling products and services, perhaps you need to review your priorities. Check out this website for a whole raft of tips and ideas for making better use of your time. (www.time-management-guide.com)
- Spending money without checking what you are actually getting for your cash is a sure fired way to waste money. Sounds insane, but we are nearly all guilty of this. Nearly every business spends money on advertising in some form or another – leaflets, mail outs, brochures and so forth. But very few bother to check the response rate from this activity. See what promotional activity works best for your business. Cut out the ones that don't work and concentrate on the ones that do.
- Most of us use price comparison websites for our personal purchases but can be less thorough when it comes to business buying. Sir Philip Green, Top Shop's boss, who carried out a review of government spending published in October 2010 (http://download.cabinetoffice.gov.uk/efficiency/sirphilipgreenreview.pdf) identified that different departments paid between £353 and £2,000 for the same model of computer. There are over 200 price-comparison websites covering computer hardware and software, phones, travel, credit cards, bank accounts, loans, utilities, electrical goods, office products and printer supplies, and a few thousand more items a business might purchase. Paler.com, a quirky website run by Petru Palre

(www.paler.com> UK Price Comparison Sites) has a directory listing these sites, with brief explanations and a helpful comments page where users have inserted more sites and additional information.

Reducing Shrinkage

You may believe that just because your business sells no tangible products or isn't a retailer with a regular influx of unknown and unknowable visitors that your risk from theft or fraud is low. You may feel even more secure if you don't handle cash or any form of face-to-face transaction. If you draw comfort from any of these positions the chances are that you're wrong. The statistics are truly scary.

RSA, a UK insurance company that regularly surveys theft in the workplace reported in April 2009 that:

- 54% of employees admit to pilfering from their employer
- Nine in ten businesses do not protect against employee theft
- Offices are twice as likely to fall victim to light-fingered staff than manual workplaces
- One in twenty employees confessed to stealing more valuable items such as mobile phones or computer hardware

Retail Theft Barometer, the world's largest and most comprehensive survey on the subject, reckons that retail shrinkage costs businesses worldwide in excess of $1 billion.

The Association of Certified Fraud Examiners (www.acfe.com) estimates that the typical business loses an average of 6 per cent of revenues from employee theft alone. Follow these tips for minimising business theft:

- Be careful in hiring and vigilant in supervision.
- Implement basic controls across all areas of the organisation, both internal and external.
- Never let one person control all aspects of a business area.

Perhaps the most alarming recent development is business identity theft, that serious but common threat that so embarrasses companies that they keep their victimisation secret. One technique that criminals use is changing the registered office address at Companies House and having goods delivered to the 'new' address. By the time suppliers realise what's happening the tricksters have moved on. Even the professionals in the field are at risk here. Namesafe, a business identity protection firm, sued LifeLock, a competitor, claiming it had stolen its trademark and deceptively diverted traffic meant for Namesafe's website to LifeLock's own website. The law suit claimed that LifeLock had bought sponsored ads on major search engines and portals including Google, Yahoo, MSN and Hotbot diverting users to its site.

These steps will minimise the chance of becoming a victim of identity fraud:

- Register with PROOF: (PROtected Online Filing, http://www.companieshouse.gov.uk/infoAndGuide/proof.shtml) Companies House has a scheme to make it difficult for fraudsters to change the details of a company's directors and registered office.

- Protect your wireless network: Many businesses operate a virtually open internet system that in effect gives any hacker unrestricted access to all their business information – customer names, bank accounts and much more. At a minimum you need to turn on WEP (wired equivalency privacy) or WPA (Wi-Fi protected access) on all of your devices, including your router. Check out Microsoft's (www.microsoft.com/uk/smallbusiness/business-goals/security/default.aspx) practical advice on how to protect home based wireless internet.
- Use a strong password: This should be at least eight characters long and have a combination of lower and upper case letters, numbers, and symbols. Change your password at least four times a year.

Negotiating with Suppliers

Fewer than 1 in 20 owner-mangers negotiate for better deals from their suppliers, and managers, with the exception of professional buyers, aren't much more likely to either. This, however, is one area where you can probably strip a per cent or two out of costs and add them to the bottom line for just a few minutes' work.

Negotiating is as much a science as an art. A few immutable rules exist; easily understood but invariably difficult to execute.

- Aim high at the outset. Unless you can find the point of resistance you can't find the outer limits of your negotiating range.

- You must be prepared to walk away from a deal and make that evident if you're to have any negotiating leverage. To achieve this you must have prepared plans B and C ready to execute if the terms you want can't be achieved. For example, have other suppliers in the frame too; or have plans to buy substitute materials and do without them altogether.
- Search out a range of variables to negotiate other than price that might be of value to the seller. Delivery date, payment terms, quantities, currencies, shared future profits and know-how swaps are just a handful of areas rich in negotiating possibilities.
- Never give a concession away: anything given for nothing is seen as being worth nothing. Instead, trade concessions and always put the highest value possible on the concession. 'We will pay 30 per cent upfront rather than the 20 per cent you're asking for (a gain for the seller) if you bring the price down to £1.2 million rather than the £1.3 million you're asking' (a gain for the buyer) is the place to start if you hope to hit a £1.25 million final price.
- Talk as little as possible. The less you say, the less you can give away.
- After you've put a proposition on the table, shut up. The first to blink is the loser.

Companies such as Collective Purchasing (www.collectivepurchasing.co.uk) collect pricing information to help you negotiate without compromising on quality.

Consider buying in bulk or longer-term contracts, but only if the discount is higher than your cost of capital. Join an online buying group such as Buying Groups (www.buyinggroups.co.uk), Power Purchasing Group (www.ppg.co.uk) and e-Three (www.e-three.com), which help buyers to join forces, and by buying in bulk, can get better prices and terms of trade.

Going In for Benchmarking

One way to get a feel for how to set cost-improvement targets is to see what the best companies in your sector are achieving. If, for example, an admired competitor is getting its audit carried out for £5,000 and yours is costing £20,000, that information represents a potential cost-saving opportunity.

These are the key sources of financial performance and relative cost structures to draw on when setting cost-improvement budgets:

- **Companies House** (www.companieshouse.gov.uk) is the official repository of all company information in the UK. You can use the WebCHeck service, free of charge, to search for details of 2 million companies, either by name or unique company registration number.
- **FAME** (Financial Analysis Made Easy) is a powerful database that contains information on 3.4 million companies for companies in the UK and Ireland. You can compare each company with detailed financials with its peer group based on its activity codes and the software lets you search for companies that comply with your own criteria, combining as many conditions as you like. FAME is available in business libraries and on CD from

the publisher (www.bvdinfo.com, which also offers a free trial.

- **Free Annual Reports** is an online service from PrecisionIR Group (www.investorcalendar.com/research/index.asp)offering free instant downloads of financial reports from listed companies in Europe and North America.
- **Key Note** (www.keynote.co.uk) operates in 18 countries providing business ratios and trends for 140 industry sectors providing information to assess accurately the financial health of each industry sector. Using this service you can find out how profitable a business sector is and how the successful the main companies operating in each sector are. Executive summaries are free, but expect to pay between £250 and £500 for most reports.

Getting Kitted Out for Less

You'll almost certainly have to buy in either office furniture or equipment to run your business with, but this needn't break the bank because plenty of sources offer good quality at a low cost.

- For **new furniture** supplied to most European countries and around the world check out Amazon (www.amazon.co.uk), IKEA (www.ikea.com) and Habitat (www.habitat.net).
- For **second-hand office furniture** search WantDontWant.com (www.wantdontwant.com), Green Works (www.green-works.co.uk), which has outlets around the UK, and Office Furniture Desks and Chairs (www.officefurnituredesksandchairs.co.uk). Choosing

from these websites you could fit out a basic office for less than £50.

- For **machinery and equipment** use a trade magazine. Alternatively, Friday-Ad (www.friday-ad.co.uk) and Machinery Products UK (www.machineryproducts.co.uk) sell second-hand machinery and tools of every description.

Over 200 price comparison websites exist that cover computer hardware and software, phones, travel, credit cards, bank accounts, loans, utilities, electrical goods, office products including inkjet and printer supplies and a few thousand more items a business might purchase. Paler.com, a quirky website run by Petru Palre (www.paler.com) has a directory listing these sites, with brief explanations and a helpful comments page where users have inserted more sites and additional information. Paler.com also has a directory for international supplier comparison sites that's split into the United States and International (go to UK Price Comparison Sites and then US/International).

Setting Cost-cutting Priorities

Clearly, you can't do everything at once when it comes to cutting costs so it makes sense to prioritise the tasks in some way that recognises that not all actions are equally easy to carry out, nor do they have equal cost savings potential.

Figure 21-1 provides a framework to help with such decisions by ranking actions using two basic criteria: the ease or difficulty of carrying out the task and the likely savings to be achieved after the task is accomplished.

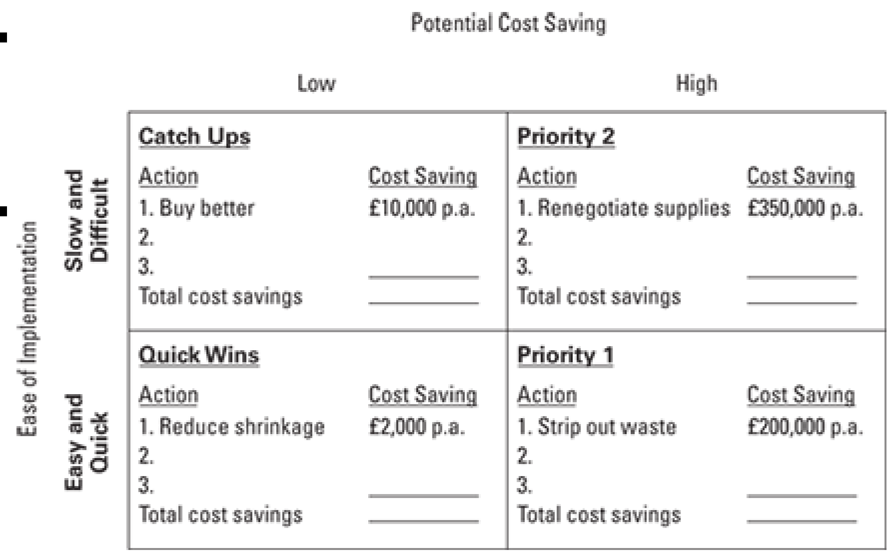


Figure 21-1: Setting cost cutting priorities.

This example shows that you can make some sizeable savings quickly by stripping out waste, which puts it in the Priority 1 quadrant. Renegotiating with suppliers could make even larger savings, but these will take time because the business has contracts to unwind, making this a candidate for the Priority 2 quadrant. Reducing shrinkage is labelled as a ‘Quick Win’, because it may be easy to implement but doesn’t reduce costs significantly. You can implement Quick Wins alongside Priority 1 tasks, or at any stage that you need morale boosting savings to reassure managers that cost-cutting targets can be met, or when political signals are required, to demonstrate, for example, to shareholders that a cost-saving programme is underway. The savings from Quick Wins are usually too small to spend much time on, but can prove valuable nevertheless. The final quadrant headed ‘Catch Ups’ comprises difficult tasks that won’t reduce costs by much, and that you should leave to last.

Chapter 22

Ten Steps to Prepare to Move On

In This Chapter

- Deciding when to sell up
- Putting a price on your business
- Getting the best advice
- Figuring out what to do next

However much you love your business, the time comes when you want to realise some or all of the value tied up in the business. It may be just that you want to buy a yacht and have the time for that round-the-world adventure you've been promising yourself; it may be that you've taken the business as far as you can and to realise its full potential it needs another skipper at the helm; or it may be that your backers, if you have any, want to bail out themselves – venture capital firms often have itchy feet and want to take their profits from one sector to pile them into the next big thing. Whatever the reason for looking for an exit, to get the best value out of your business follow these ten guidelines.

Monitoring Market Prices

Timing is crucial when it comes to selling a business. Since 1900, 27 'bull' markets have existed, when company shares rise sharply, with corresponding 'bear' markets, the latest example being in 2008–2010, when over-optimistic investors get mauled as the bottom drops out of stock markets. These ups and downs can result in very steep curves, with business values oscillating by as much as a 50 per cent and the changes in the market's perception of value often having little to do with the actual performance of businesses themselves.

Businesses listed on the stock market have no difficulty in working out what their businesses are worth at any moment in time – share prices are published daily in the financial press and every few minutes on financial websites. But because most businesses, yours in all probability included, aren't listed on a stock market, you can't easily keep tabs on market sentiment for the value of your business.

Step forward BDO Stoy Hayward and take a bow. BDO Stoy Hayward's Private Company Price Index (PCPI) tracks the relationship between the current FTSE price/earnings ratio (P/E; check how to calculate this in Chapter 5) and the P/Es currently being paid on the sale of private companies. Put simply, the PCPI lets a company without a stock market listing get a reasonable idea of what it may actually sell for now. Go to www.bdo.uk.com/library/a-z > PCPI Private Company Price Index.

Valuing Your Business

Setting a precise value on a business isn't quite as simple as, say, determining the price of your home. One possible way is to add up the assets, take away the liabilities and in theory the difference is the value of your business. However, your assets comprise items such as stock that may be hard to value, and debtors who may or may not actually pay up. (I cover these terms in Chapter 13.) Businesses are more usually valued using a formula known as the price/earnings ratio (I show how this is calculated in Chapter 5). P/E ratios vary both with the business sector and current market feeling about that sector. The market as a whole generally trades with P/Es of between 14 and 20, with the average since 1870 being 15.

You can check out the P/E for your business sector either by looking in the *Financial Times*, or at ProShare's website (www.proshareclubs.co.uk, then click Research Centre, then Performance Tables). You need to register to access the data on the ProShare website, but registration is free. There you can see the current P/E ratio for every company in your sector, as long as they're listed on the London Stock Exchange. If you want to see how much interest exists in your business sector right now, visit Interactive Investor (www.iii.co.uk, select Markets and then Sectors). There you can see the sector whose shares investors have bought and sold the most over the past day, month and year.

Private companies don't trade on as high a P/E multiple as their big brothers on the stock market. So if a public company in your sector is on a P/E of 12, as a private company your prospective P/E is around 8, or a third less. Why? Good question. The simplest answer is that although shares in your business are hard to dispose of, you can unload a public company every business day by making a phone call to your broker. In other words, the premium is for liquidity.

Figuring Out Who to Sell To

Determining a selling price is one thing, but finding a willing buyer is a much more challenging task. Price and buyer are inter-related factors, because whatever equation you use to arrive at business value, at the end of the day a business is only worth what someone with the dosh can pay. These are your options:

- **Sweetheart deal:** Selling out to someone you know or do business with is an easy option. Unfortunately, it's not always the way to get the best price for your business, because only one buyer is in the frame. Not only does it take two to tango, but your sale works better if you have at least two people interested in buying your business.
- **Trade sale:** This is when you sell out to another company, usually a much larger one with access to finance and other resources that may enable your business to have a continuing future. This involves publicising that you're selling up and creating the environment for several bidders to enter the ring. You can sell the business yourself, perhaps by advertising or by word of mouth. But usually you appoint a business broker to handle the deal, much as you'd use an estate agent to sell your house.
- **Management buy-out (MBO):** You may be able to sell your business off to your management team. That involves them raising the money, perhaps from a venture capital firm (I cover this subject in Chapter 8). You can find out more about MBOs from the Centre for Management Buy-out Research (CMBOR), founded by Barclays Private Equity and Deloitte at the Nottingham University Business School (www.nottingham.ac.uk/business/cmbor).
- **Management buy-in:** This involves selling the business to a new management team, invariably with the financial backing of a venture capital firm. The team is led by someone, usually from a similar industry to yours, who's

proved successful in building up and selling out a business before.

BIMBO is a combination of a management buy-in and buy-out, usually involving an external managing director being brought in to run your business with your management team and financial backing from a venture capital firm.

- **Employee benefit trust:** This involves forming a trust to hold shares on behalf of employees, so that the employees can in effect end up owning a substantial slice of the business. Some tax incentives are available to retiring owners who sell (or gift) shares to such a trust. You can find out more about this option from Employee Ownership Options (www.employeeownership.co.uk/finance.htm). Its goal is to raise awareness of the business options available to small firms when they're threatened with closure either as a result of succession problems or as a result of divestment.
- **Going public:** This involves selling shares in the business to the public through a stock market flotation. In that way you can realise some of the value in your business gradually over a period. This is a complicated and expensive process and you need professional advice. AIM, the junior UK stock market, has seen over 3,000 companies listed since it started in 1985, some of which have at best a modest trading record. Check out the London Stock Exchange (www.londonstockexchange.com/companies-and-advisors/aim/for-companies/joining/aim.htm) for a full description of the options, what's involved, how much it costs (lots!) and who can advise.

- **Passing on to the family:** Less than 33 per cent of family businesses are passed on to the second generation and barely 13 per cent survive through to the third generation. So much for the bad news – the ones that do can be very successful. ALDI (short for 'Albrecht Discounts'); Michelin, controlled and run by François Michelin, his son Edouard and their partner René Zingraff; and Mars, founded by Minnesotans Frank and Ethel Mars, who invented the Milky Way bar, are among the world's biggest family businesses (check out *Family Business Magazine* at www.familybusinessmagazine.com, then Oldest Family Companies for a full list). The Family Firm Institute (www.ffi.org), the International Centre for Families in Business (www.icfib.com), Peter Leach LLP (www.peter-leach.com), who started the Family Business Centre at accountants BDO Stoy Hayward and now runs it as a stand-alone venture, and the Family Business Institute (http://familybusinessinstitute.com) are organisations dedicated to providing education and networking opportunities for family businesses, as well as help with succession planning.
- **Selling the assets:** If the business can't be sold, perhaps because it's unprofitable, or because it's a one-man band and has no prospects of operating without the owner, then the remaining option is to sell off the assets, pay out what's owed and pocket what's left.

You almost certainly already know the name of the buyer of your business. Make a list of all the competitors, customers, suppliers and employees who you believe may benefit from taking over your business. Then trawl the financial press to see who else has bought or been involved in any way in the sale of a company similar to yours. Check out *Acquisitions Monthly* (www.aqm-e.com) to see what deals have been done and what active buyers are in the market; and *Daltons Business* (www.daltonsbusiness.com/SearchStat.asp), where you can see the market demand statistics by different types of business.

Dressing to Kill

Whoever you plan to sell your business to, you should plan ahead to make the business look its best. Blemishes such as poor profit performance, bad debts, credit downgrades and being dragged through the courts by ex-employees claiming to have been unfairly dismissed aren't desirable. You should try to make the three years prior to your exit look as good as possible. That means profit margins should be consistently high, the sales and profit curve should be heading upwards and strong financial control systems should be in evidence.

Check out these organisations to see how your business is likely to appear to a would-be buyer.

- Inter Company Comparison (www.icc.co.uk) and Jordans (www.jordans.co.uk) provide regularly updated online company information services that enable users to access and retrieve data on individual companies, directors and shareholders. They also enable users to produce industry, group, peer and individual reports, allowing you to compare your business's performance with that of other similar companies, as well as obtaining in-depth financial profiles.
- Creditgate.com (www.creditgate.com) and Credit Reporting (www.creditreporting.co.uk/b2b) are among a

growing number of companies that offer a comprehensive range of credit reports instantly online, including credit check, credit rating, company profile, credit score, credit reference, credit limit, company directors and county court judgments (CCJs). You can get your own business rating from one of these agencies to see how you appear to a would-be buyer.

- The Centre for Inter-firm Comparison (www.cifc.co.uk) helps businesses of every kind improve their profitability and productivity by providing expertise in benchmarking, performance measurement and financial control. It gathers financial information on industries based on detailed information that participating firms provide – in absolute confidence – on a comparable basis. The Centre then provides the information showing industry average and best and worst performance standards, without, of course, revealing the individual participants' data.

When you want to bring a purchaser to the negotiation table, you need to prepare an initial marketing document called a *sales memorandum*. The management write the initial draft and your corporate adviser then polishes it up. It should:

- Make the business sound attractive and feature product literature, photographs, charts and tables.
- Be a source of solid information, but not over-full of numbers and analysis. The buyer and their adviser will get your accounts themselves.
- Show that the business has scope for improvement and development if someone with more money and wider

skills and experience takes it forward. Otherwise it's hard for potential buyers to see what value they can add.

- Contain no detailed confidential information or commercially sensitive information, such as the name of customers or suppliers. No buyer makes a final decision on the basis of a sales memorandum, so you can provide this information later to serious buyers only.
- Be tailored to meet the needs of different potential buyers. For example, competitors know a lot about the industry and your products, so you don't need to explain that to them.

Finding Advisers

The information in this chapter should give you an idea of what you need to know in order to exit from your business successfully. But although you should know the questions, you need advice with finding the answers. These organisations can help you find professional advisers and advice from those experienced in selling businesses:

- HW is a national business advisory and accountancy firm with a network of over 60 offices strategically placed throughout England, Wales and Scotland, offering advice on a range of financial matters including specific help with selling your business (www.hwca.com/business-services/buying-and-selling-businesses/).
- Business Link (www.businesslink.gov.uk, then select Buy or Sell a Business and then Getting Ready to Sell) has a comprehensive range of advice covering everything from preparing your business for the sale to handling

potential redundancies, including links to sources of professional help.

- BDO Stoy Hayward, an accountancy firm, has a publication, *Guide to Selling Your Business* (available from www.bdo.co.uk), which sets out its service offer to entrepreneurs planning to sell up.

Getting the best corporate finance advice, as the whole subject of selling and buying a business is known, isn't cheap. Expect to pay out between 3 and 7 per cent of the value of your business, and to have to lay out a largish five-figure sum on the table to kick things off. But good advice can double the amount of money you actually end up with when you take tax, pensions and warranties into consideration.

Doing Due Diligence

When you buy a house, you and your surveyor crawl over everywhere with a tape measure to check out sizes, and employ various instruments to see whether any damp, dry rot or other unpleasant infestation exists that could affect its value. Your lawyer makes sure that the sellers actually own the property, no mortgage is outstanding and no imminent plans exist to build a motorway through the garden. A very similar process happens when businesses are bought and sold, in a process known as *due diligence*. The accounts have to be correct, tax paid up to date and mortgages declared, and any lawsuits rumbling in the background for unfair dismissal of employees, disputes with suppliers or defective products supplied need to be flushed out into the open.

At the end of the due diligence process, lots of people end up with liabilities. The corporate finance firm and the lawyers are responsible for the quality of their advice and if they get it wrong they can be sued. The accountants are responsible on your side for delivering proper accounts and on the buyer's side for interpreting them correctly. The seller too has to give guarantees that she's told the truth, the whole truth and nothing but the truth. If that proves not to be the case, she may miss out on a slug of the sale price.

Sellers are usually required to give *warranties and indemnities* to the buyer to the effect that every important thing she says about the business and its accounts is true, and that she's have left nothing material unsaid. By way of guarantee, a portion of the selling price isn't paid up for a period of a year or so, giving time for the buyer to uncover skeletons.

AllBusiness.com, a website with resources for entrepreneurs including how-to articles, business forms, contracts and agreements, expert advice and blogs, has a free 40-point due diligence checklist (go to www.allbusiness.com, then select Shop Legal Forms, then Mergers and Acquisitions, then Due Diligence Checklist). You can buy the full Monty for $25.

Earning Out Your Profits

One trick that buyers and their canny advisers use to make sure that your business is really worth all the bundles of dough they're paying out is to make you do some of the hard work for them. The thinking behind this is that because you've been running the firm for years, no one's better qualified than you to make sure that you keep sweet customers and suppliers with whom you presumably have a good working relationship.

Typically, if an earn-out is proposed it's for between 10 and 30 per cent of the sale price and covers a period between one and three years. The rule here is that sellers should resist such proposals and buyers should insist!

Most of the costs involved in selling your business are based on a percentage of the selling price. That figure includes the earn-out amount, whether or not the figure is actually achieved. Some unique tax implications exist that you or your adviser should check out with HM Revenue and Customs (www.hmrc.gov.uk/manuals/ersmmanual/ERSM110000.htm).

Starting Up Again

Having worked out how to start a business, build it up and sell it on, you may be justified in thinking that you have a winning formula for making money: just keep turning the handle. One business founder who came on a programme at Cranfield School of Management bought out a chain of three pubs, built it up to a dozen and then sold out to a national brewery chain for a healthy profit. He repeated the process three times more and for all I know is still following his simple but effective business model. The value he discovered was that big brewers didn't want to buy a pub or two at a time. That's too much like hard work. In any event, it takes as much management time to buy one pub as it does to acquire a chain.

A buyer doesn't want to pay you for a business only to find out that you start up a new business and become a competitor. A buyer expects you to sign a non-compete clause as part of the sale contract. This requires you not to compete for a certain number of years within a designated geographical area. The good news – for sellers, that is – is that such agreements are difficult to enforce and aren't always looked on favourably by the courts, because they restrict an individual's employment options.

Becoming a Business Angel

If you don't want to run a business but do want to stay involved, then you can consider becoming a business angel, backing other people's businesses with your money and expertise. I cover this subject in the section on business angels in Chapter 8.

Robert Wright started up his business, a one-plane regional airline, straight from business school; he'd already qualified as a pilot. Robert built the company, trading as City Flyer Express, up to a substantial venture and sold it to British Airways for a sizeable eight-figure sum. Over the years following the sale he took stakes in a handful of small businesses and some not so small ones, such as Wizzair.com, using only a modest fraction of the gain made from the sale of his own company.

Winding Up

If for any reason a business appears to have no value, perhaps because it's making losses and has no assets worthy of the name, it may still be possible to salvage something from the wreckage. In the worst case your creditors can apply to wind your business up if they're owed more than £750. They can serve a statutory demand (Form 4.1) for the money due and if it's not paid or secured, or a settlement isn't agreed, within 21 days, they can appoint a liquidator. The liquidator's job is to pay off the creditors, starting with herself. No realistic likelihood exists of anything being left for the owner(s) going this route.

Before you reach this stage you should take professional advice urgently, not least because you may be liable for more expenses than you think. In theory, if you're trading as a limited company then your liabilities are capped at your stated share capital. However, trading on after the business has become insolvent leaves the directors open to a charge of wrongful trading. In such cases the directors can be personally liable for the company's debts.

Talk with your accountant, check out your position by reading up on the government's Insolvency Service website (www.insolvency.gov.uk) or contact a member of the Insolvency Practitioners' Association (www.insolvency-practitioners.org.uk). A directory of members is on the website.

To access the cheat sheet specifically for this book, go to www.dummies.com/cheatsheet/startingabusinessuk.

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About the Authors

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Steven Peterson is a senior partner and founder of Home Planet Technologies, a management training company specialising in hands-on software tools designed to enhance business strategy, business planning and general management skills. He is the creator and designer of The Protean Strategist, a state-of-the-art computer-based business simulation. The simulation creates a dynamic business environment where participants run companies and compete against each other in a fast-changing marketplace. Each management team in the simulation is responsible for developing its own strategy, business plan and program to make the plan work.

Steven has used The Protean Strategist to add excitement, hands-on experience, teamwork and a competitive challenge to corporate training programmes around the world. He has worked with both large and small companies on products and services in industries ranging from telecommunications to financial services and from high technology to consumer goods and industrial equipment. He can be reached by e-mail at `peterson@HomePlanetTech.com`.

When he's not planning his own business, Steven is planning to remodel his 80-year old house or to redesign the garden. And he confesses that of the three, the garden proves to be the most difficult. Steven holds advanced degrees in mathematics and physics, receiving his doctorate from Cornell University. He teaches part-time at the Haas School of Business, University of California at Berkeley, and lives in the Bay Area with his long-time companion, Peter, and their long-lived canine, Jake.

Colin Barrow was until recently Head of the Enterprise Group at Cranfield School of Management, where he still teaches on entrepreneurship on programmes. He is also a visiting professor at business schools in the US, Asia, France and Austria. His books on entrepreneurship and small business have been translated into twenty languages including Arabic, Russian and Chinese. He worked with Microsoft to incorporate the business planning model used in his teaching programmes into the software program, Microsoft Business Planner, now bundled with Office. He is a regular contributor to newspapers, periodicals and academic journals such as the *Financial Times, The Guardian, Management Today* and the *International Small Business Journal.*

Thousands of students have passed through Colin's start-up and business growth programmes, raising millions in new capital and going on to run successful and thriving enterprises. He held non-executive director appointments in two venture capital funds, is on the board of several small businesses and has served on a number of Government Task Forces.

Dedication

Paul Tiffany:

For the thousands of students and executives whom I have taught in the past, and who have provided me with constant inspiration and insight about the challenges facing management in the modern world.

Steven Peterson:

To my parents, Mary and Pete, for always being there to encourage and support me in whatever path I chose to pursue. Your love and devotion to each other and our family are beyond measure. And to my sister, Susie, for her deep and constant friendship, and for giving me the chance to be a big brother and an uncle.

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— Colin

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— Paul and Steven

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Business Plans For Dummies®, 3rd Edition

Visit www.dummies.com/cheatsheet/businessplansuk to view this book's cheat sheet.

Table of Contents

Cheat Sheet

Introduction

So you pulled this book off the shelf and decided to give us a try. Good move. You've come to the right place. Believe it or not, we don't need to read tea leaves to know a bit about your background. In fact, we'd go so far as to suggest that you probably find yourself in one of the following situations:

- You've a great idea for a brand-new gadget and can't wait to get your own company up and running.
- Your boss just turned over a new leaf and wants a business plan from you in three weeks.
- You've always run the business without a business plan, and you're the one who turned over the new leaf.
- You thought you had a business plan for the company, but it doesn't seem to be doing the job that it should.
- The business and economic climate looks a whole lot more hostile than the last time you thought about writing a business plan and you want to be doubly sure of getting it right.

Are we close? Whatever your situation, you're not going to need those tea leaves to make a business plan, just read this book instead. We can't tell you the future of your business. But the business plan that we help you put together prepares you for the future. And we're with you every step of the way.

Why You Need This Book

You may not know how to make a business plan just yet, but you're smart enough to know that a plan is important. We know, from years of working with companies large and small, that a business plan is crucial – your plan is the only way that you can get where you want to go.

This book helps you create your business plan step by step. Along the way, you may discover things about your business that you never realised – things that just may help you beat the competition. We even throw in a few laughs as well.

Sure, for some of you, a business plan is something that you're required to put together to raise money for a startup company. At best, it's a formality; at worst, a real pain in the neck. But a business plan isn't just there to raise money; it can also be a powerful tool – one that's bound to make your company a better place to work and your business a more successful operation.

Is a business plan magic? No – no sorcery here. A business plan works because it forces you to stop and think about what you're doing. It prompts you to figure out what you want your company to be in the future and how you intend to make the future happen. Then your plan acts as a template, guiding you through the steps required to meet your goals. For example:

- A business plan requires you to look carefully at your industry, your customers and the competition to determine what your real opportunities are and what threats you face.
- A business plan takes a good hard look at your company as well, so that you can honestly and objectively recognise its capabilities and resources, its strengths and weaknesses and its true advantages.
- A business plan coaxes a financial report, a forecast and a budget out of you, so that you know where you stand today and what the future holds.

- A business plan prepares you for an uncertain future by encouraging you to come up with business strategies and alternatives to increase your chances of success down the road.

How to Use This Book

Business Plans For Dummies, 3rd Edition will help your business succeed no matter who you are or what your job description is, whether you're part of a large corporation or a one-person show. Depending on your situation, you may find yourself dipping into and out of the book in different ways:

- If business plans are new to you, you may want to start at the beginning and let us be your guides. We take you from your company mission all the way through to making your business plan work, and we keep your head above water the whole way.
- If you're a little more experienced, you may want to head straight for one of the more interesting watering holes: how to recognise the critical success factors in your business, for example, or where to look for your company's strengths and weaknesses. After dipping in anywhere along the way, you'll most likely discover yet another section where you want to spend some time.

Just remember – no matter where you find yourself, you're never too late to start a business plan, and never too late to make the one that you have even better. In each case, you can find what you're looking for between these bright-yellow covers.

How This Book Is Organised

Business Plans For Dummies is divided into six parts, based on the major elements of your business plan. You don't have to read all the parts, however, and you certainly don't have to read them in order. Each chapter is devoted to a particular business-planning topic, and you may need some chapters more than you do others. Feel free to skip around; pick and choose what you're really interested in.

Part I: Determining Where You Want to Go

When putting together a business plan, you have to decide where you want to end up in the future. This part helps you get on track right away by establishing a mission for your company, along with business goals and objectives. Then we help you examine your company's values and your vision for the future.

Part II: Sizing Up Your Marketplace

To make a useful plan for your business, you have to know something about the market you're going after. In this part, we help you examine your industry and figure out what it takes to be successful by identifying where your opportunities and threats come from. We also help you analyse your customers, so that you can understand who they are, what they need and how you can group them to better serve them. Finally, we help you scope out your competition, trying to determine exactly what you need to win.

Part III: Weighing Up Your Company's Prospects

In this part, we turn our full attention to your company. We help you look as objectively as you can at your capabilities and resources, identifying the strengths that you can count on and the weaknesses that you need to deal with. We also help you zero in on what you do best, enabling you to figure out the real value that you provide for your customers and the true advantage that you have over your competitors. Finally, we guide you through your finances and help you put together a financial forecast and a budget.

Part IV: Looking to the Future

The main reason why you make a business plan in the first place is to get ready for what lies ahead for your business. Part IV helps you look into your future and prepares you for change. We introduce several standard alternatives and show you how you can use them to come up with strategies of your own. And we consider the different directions that you can take as your company grows bigger.

Part V: A Planner's Toolkit

Your business plan is no good if you can't put it to work. In this part, we help you shape your company to be as efficient and effective as it can be. We also help you prepare the people in your company so that they've the skills they need to accomplish the goals set out in your plan. Finally, we show you a sample of a real business plan, so that you know – start to finish – what you're aiming for.

Part VI: The Part of Tens

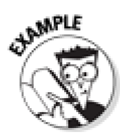
The Part of Tens is a collection of reminders, hints, observations and warnings about what to do – and not to do – as you work through your business plan. These chapters focus on the big picture, so look at them whenever you need a little perspective on where you stand and where you're headed, especially if the road ahead starts to look a little bumpy.

Icons Used in This Book

To guide you through your business plan preparation, we include icons in the left margins of the book. Here's what they mean:

This icon indicates tips to put you way ahead of the competition.

Wherever you see this icon, you find definitions of business-guru terms.



This icon calls your attention to illuminating examples from the business world.

This icon flags situations that apply mostly to large companies, but that may help small companies as well.

Ouch!, you may get burned unless you heed these warnings.

This icon serves as a friendly reminder that the topic at hand is important enough for you to note down for the future.

This icon lets you know about websites from which you can download free financial spreadsheets, tables and other useful goodies. These can help take the grunt and groan out of number-crunching cashflow forecasts, ‘what if’ projections and other tedious but vital repetitive calculations, as well as keep you up-to-date on important rules and regulations.

Where to Go from Here

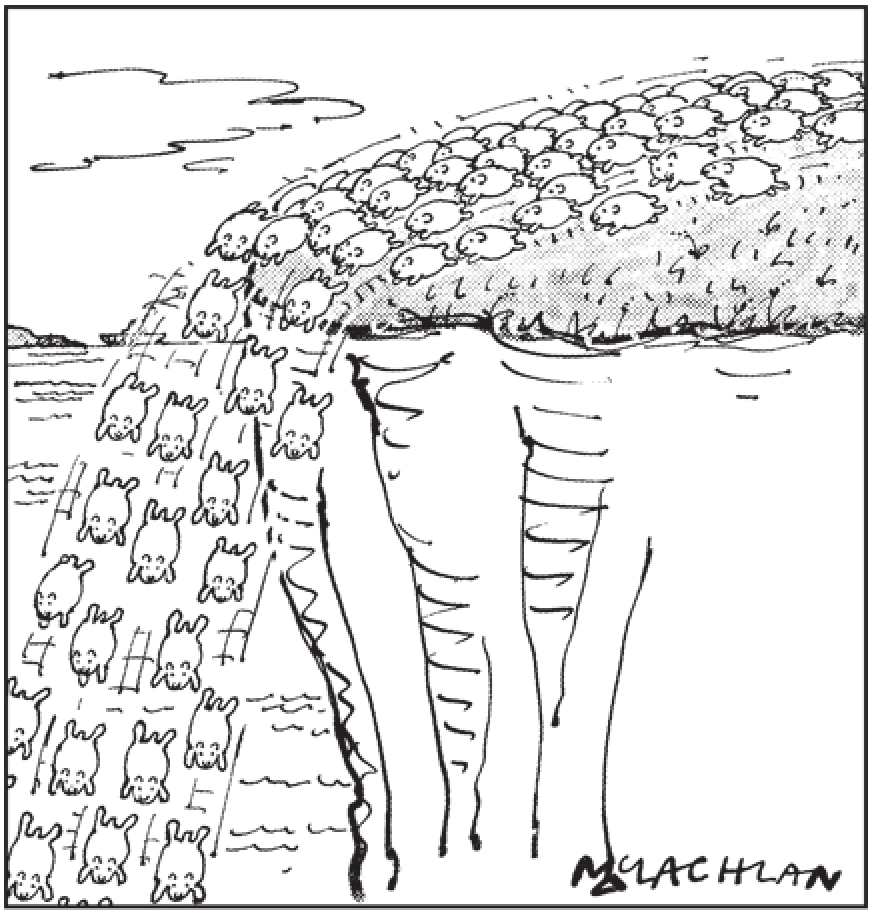
Take a minute to thumb through this book and get comfortable with what’s inside. Then pick out one or two chapters that tickle your fancy. Better yet, turn to a chapter that you already know something about. Or, if you’re really daring, turn the page and start at the beginning.

Don’t forget to use the table of contents for a chapter-by-chapter breakdown. The index is also an excellent place to turn to find a specific topic right away.

Want to make your business plan look great, or need some hands on support? Go to www.dummies.com/go/businessplansfordummies to find tips and advice on shaping up your business plan. You can also download a glossary from here to get your head around the business jargon.

Part I

Determining Where You Want to Go



'In a previous life, before I became a lemming, I was a small company without a business plan'

In this part . . .

No matter what you'd like to finish, from wallpapering the bedroom to hooking up the new router, it's awfully easy to pass over all the preliminary stuff and jump right into the thick of the project. Let's face it, the preliminaries are a bit boring. But for the really important things in life – and in business – preparation is everything. So preparing to do your business plan ranks right up there in importance with each of the other major steps as you create a plan.

In this part, we help you prepare to plan by looking at what a business plan is all about. First, we look at how to establish a mission for your company and develop business goals and objectives with all your stakeholders in mind. We also point out why values are so important to your company, and show you how you can use your company's values. Finally, we look at how a vision for your company gives you something to aim for and a direction to take.

Chapter 1
Starting Your Business Plan

In This Chapter

- Getting the most out of your plan
- Using your plan as a record of the past and a guide to the future
- Making your plan function as your company description
- Figuring out how to address your different readership
- Checking out what the written plan looks like

Most of us go through life thinking ahead. We plan to paint the house, plan to go back to university, plan to take a holiday and plan for retirement – we always have a plan or two in the works. Why do we plan so much? We certainly can't predict what's going to happen, so why bother? Certainly, none of us knows the future. But each of us knows that tomorrow will be different from today, and today isn't the same as yesterday. Planning for those differences is one way to move forward and face things that are unfamiliar and uncertain. Planning is a strategy for survival.

Companies make business plans for many of the same reasons. Planning is a strategy to improve the odds of success in a business world that's constantly changing. Business plans are not a guarantee, of course. Business planning isn't a science that offers you right and wrong answers about the future. But business planning is a process that gets you ready for what's to come. And making a plan increases the likelihood that down the road, your company will be in the right place at the right time.

In this chapter, we explore what planning is all about, how you can use your business plan and why having a plan is so important. We talk about your business plan as a guide to your company's future, as well as a record of where you've been and how you've done. Because your plan is a ready-made description of your company, we also talk about the kinds of people who may be interested in seeing your business plan. Then we help you get a handle on who needs to be involved in putting your plan together, depending on how big your company is. Finally, we show you what your business plan should look like on paper.

Getting the Most Out of Your Plan

A *plan* originally meant only one thing: a flat view of a building, viewed from above. If you've ever had a house built or remodelled, you know that this kind of plan is still around (and still expensive). Over the centuries, however, the meaning of the word *plan* has expanded to include time as well as space. A *plan* in the modern sense also refers to a view of the future, seen from the present. You make plans for a birthday party next week or a business trip next month.

TIP

A *business plan* is a particular view of your company's future, describing the following things:

- What your industry will look like.
- What markets you'll compete in.
- What competition you'll be up against.
- What products and services you'll offer.

- What value you'll provide customers.
- What long-term advantages you'll have.
- How big and profitable your company will become.

To create a detailed view of the future, you have to make a lot of predictions about what's going to happen down the road. If your company manufactures crystal balls, of course, you're in luck. If not, you have to find other ways to make basic business assumptions about the future, which we share with you throughout this book.

In the end, your business plan is only as good as all the assumptions you put into it. To make sure that your assumptions make sense, much of your planning should involve trying to understand your surroundings today – what's going on right now in your own industry and marketplace. By making these assumptions, you can better predict your business and its future. Will your predictions actually come true? Only time will tell. Fortunately, the planning process makes you better prepared for whatever lies ahead.

Looking to the future

A business plan provides a view of the future. Whether your company is large or small, whether you're just starting a business or are part of a seasoned company, you still need some sort of planning process to point you in the right direction and guide you along the way. For example:

- A brand-new company makes a business plan to get its bearings and often uses the plan to get funding.

- An up-and-running company uses a plan to be better prepared.
- A large company needs a plan so that everybody sees the same view ahead.
- A small company makes a plan if it wants to make sure that it survives those crucial first two years.

In fact, a small company needs a business plan most of all. If you own or manage a small business, you already know that you're the jack-or-jill-of-all-trades. You hardly have enough time to get your daily business tasks done, much less plan for next week, next month or next year. But because you run a small business, you simply can't afford *not* to plan.

When a giant company stumbles, it usually has the financial reserves to break the fall and get back on its feet. If your resources are limited, however, a single mistake – such as exaggerating the demand for your products or underestimating how long you have to wait to get paid – can spell the end of everything you've invested in and worked so hard to achieve. A business plan points out many dangers, alerting you to the hazards and obstacles that lie ahead, so that you can avoid such pitfalls. Remember: two-thirds of all new businesses cease trading within their first two or three years.

Accounting for your history

A business plan paints a picture of where your company has been and how it has changed over the years. By reviewing past performance, particularly from your accounts and sales reports, you can use your plan to figure out what worked and what didn't. In effect, your business plan offers you an opportunity to keep score, allowing you to set goals for your company and then keep track of your achievements. For example:

- Your plan creates a view of the future. In years to come, you can use old copies of your plan to look back and determine just how good you are at seeing what lies ahead.
- Your plan maps out a direction to go in and the route to take. You can use it to gauge how skilful you are at accomplishing what you set out to do.
- Your plan forecasts where you want to be. You can use it to check out how close you have come to your targets for the industry, your market and your finances.

Your history, as described in your business plan, has given you important lessons about the business you're in – so you aren't doomed to make the same mistakes over and over. If you can't remember exactly where your company has been, you probably won't see where it's headed.

Anticipating your different audiences

You can use your business plan to tell the world (or at least anyone out there who's interested) all about your company. No matter who you're dealing with or why, your plan has a ready-made description to back up the claims you make. Your plan comes in handy when you're dealing with the following people:

- Suppliers you are asking to extend you credit and offer you terms.

- Distributors who want to add your product or service to their line-ups.
- Big customers who hope to establish long-term business relationships with you.
- The board of directors or other advisers who want to offer support.
- Outside consultants you bring in to help out with specific issues.
- Bankers who decide on whether or not to lend you money.
- Investors who are interested in taking a stake in your company.

All these people have their own special reasons for wanting more information about you, and each probably is interested in a different part of your plan. A well-written business plan satisfies all these groups and makes your company stronger in the process. Preparing a business plan:

REMEMBER

- Improves your company's chances of success.
- Shows you where your company has been and how it has changed.
- Provides a blueprint for the future.
- Is an ongoing process.

Steering clear of the hard sell

A business plan is a professional document, and though its primary purpose is to 'sell' your proposition to someone, it is not a sales advertisement. Look at these two statements from Tesco PLC:

- In order to reflect changing consumer needs and the increasingly global nature of our business we’ve evolved our strategy. The strategy now has seven parts and applies to our five business segments – the UK, Asia, Europe, the United States and Tesco Bank.
- So when you use your Clubcard Credit Card to pay at Tesco, not only will you get one point for every £4 you spend, you will also collect standard points from Clubcard!

The first is from Tesco’s corporate website (www.tescoplc.com/about-tesco/our-strategy), while the second is from the selling arm of their bank (www.tescobank.com/personal/finance/creditcards). If you feel that the second statement seems more puffed up you’re right. The marketing message is that using this card in Tesco gives your savings points a significant boost. But as its normal loyalty card pays eight points per £4 anyway, the credit card only adds one extra point. You actually only gain a quarter of a point per pound spent. Well, as Tesco says, ‘Every little helps’.

However competently constructed, sales literature leaves the reader with the feeling that they’re being steered, or perhaps even pushed, in a direction where their best interests are not necessarily the main purpose of the communication.

Differing the emphasis for different readers

Inevitably a business plan is aimed at a number of different audiences who have diverse if overlapping requirements.

Clearly much of the contents of the business plan need to be common to all these audiences. Your core proposition, the target markets, business strategy and operating procedures have importance to all your readers. But you may need to use the order of content, the amount of information and some of the words used on some occasions for each key reader group, to have the best chance of achieving your goal in writing up the business plan.

Investors are most interested in hearing about exciting future prospects, bankers look for evidence of a sound foundation while a prospective key employee hopes for evidence of career opportunities. If the plan is to be pitched at a corporate venture fund (see Chapter 16 for more on VCs), they want strong evidence of valuable intellectual property (see Chapter 14 for more on IP) or some other attribute that they can leverage into their own business at some point.

You may also find it useful to produce a rolling business plan to include modifications in the light of events as they develop. A successful pitch to a business angel confirming commitment in principle to provide funds can be incorporated into later editions of your business plan as a material fact. The results from customer trials not available when your business plan was written first can be added as they become available.

Putting Your Plan on Paper

When you put together a business plan, your efforts take you in many directions. You face all sorts of issues related to the business that you're in. Right off the bat, for example, you need to answer basic questions about your company and what you want it to be in the future. Then you have to decide what targets to aim for as you look ahead and set business goals and objectives.

A large part of creating a business plan requires only a dose of good common sense on your part. But if you want to make sure that your business plan succeeds, you also have to take the time to do the following:

- Look closely at your industry.
- Get to know your customers.
- Check out your competitors.
- List all your company's resources.
- Note what makes your company unique.
- List your company's advantages.
- Figure out your basic financial condition.
- Put together a financial forecast and a budget.

In addition, you have to be prepared for everything to change down the road. So you also need to think about other options and alternatives and be on the lookout for new ways to make your company prosper.

You don't want to scare people – yourself included – with a written plan that's too long. The longer your plan is, in fact, the less likely people are to read it. Ideally, for a small or medium-sized company, your written plan should be 15 to 20 pages maximum. Remember that you can always support the main text with all the exhibits, appendixes and references that you think it needs. If you want to glance at a sample business plan, jump to Chapter 17 or check out Bplans.com (www.bplans.co.uk) who have hundreds of free sample plans on their website.

To remind yourself (and other people) that your written plan is forever a work in progress, we suggest that you keep it in a three-ring binder, or its electronic equivalent. That way, you can add or delete pages and swap entire sections in or out, as your business plan changes – and we're certain that it *will* change. Fortunately, however, the format you use – all the major sections of a business plan – will stay the same.

Before you get your business plan under way, take a moment to review the following sections.

Executive summary

Your executive summary touches on everything that's important in your business plan. This summary is more than just a simple introduction; it's the whole plan, only shorter. In many cases, the people who read your plan won't need to go any further than the executive summary; if they do, the summary points them to the right place.

The executive summary isn't much longer than a page or two, and you should wait until the rest of the business plan is complete before you write it. That way, all you have to do is review the plan to identify the key ideas you want to convey.

If you want to make sure that people remember what you tell them, you have to say what you're going to say, say it, and then say what you've said. The executive summary is where you say what you're going to say.

Company overview

The company overview provides a place to make important observations about the nature of your business. In the overview, you discuss your industry, your customers and the products and services you offer or plan to develop. Although you should try to touch on your company's business history and major activities in the overview, you can leave many of the details for the later sections.

To put together this kind of general company overview, you can draw on several key planning documents, including the following:

- **Mission statement:** A statement of your company's purpose, establishing what that purpose and what it does.
- **Goals and objectives:** A list of all the major goals that you set for your company, along with the objectives that you have to meet to achieve those goals.
- **Values statement:** The set of beliefs and principles that guide your company's actions and activities.
- **Vision statement:** A phrase or two that announces where your company wants to go or paints a broad picture of what you want your company to become.

To begin constructing these statements, turn to Chapters 2 and 3.

Business environment

The section of your business plan that deals with your business environment needs to cover all the major aspects of your company's situation that are beyond your immediate control, including the nature of your industry, the direction of the marketplace and the intensity of your competition. Look at each of these areas in detail to come up with lists of both the opportunities that your business environment offers and the threats that your company faces. Based on your observations, you can then describe what it takes to be a successful company.

Pay special attention to how your industry operates. Describe the primary business forces that you see out there, as well as the key industry relationships that really determine how business gets done. Next, talk about your marketplace and your customers in more detail, perhaps even dividing the market into segments that represent the kinds of customers you serve. Finally, spend time on the competition, describing what those companies are, what they're like, how they work and what they're likely to be up to in the future.

For more information on how to explore your business circumstances and the overall environment that your company competes in, check out Chapters 4, 5, 6 and 7.

If the economic climate looks like taking a dive, head to Chapter 15 where you can find pointers to planning for the turbulent times ahead.

Company description

In the company description, you go into much more detail about what your company has to offer. The description should include information about your management, the organisation, new technology, your products and services, company operations, your marketing potential – in short, anything special that you bring to your industry.

In particular, you need to look carefully and objectively at the long list of your company’s capabilities and resources. Sort out the capabilities that represent strengths from those that are weaknesses. In the process, try to point out where you have real advantages over your competitors.

Examining your company through your customers’ eyes helps. With this viewpoint, you sometimes can discover customer value that you didn’t know you were providing; and as a result, you can come up with additional long-term ways to compete in the market.

To start to put together all the things that your company brings to the table, flip to Chapters 8 and 9.

Business strategy

The section on company strategy brings together everything that you know about your business environment and your own company to come up with your projections of the future.

You want to take time in this section to map out your basic strategies for dealing with the major parts of your business, including the industry, your markets and the competition. Talk about why the strategy is the right one, given your business situation. Describe how the strategy is to play out in the future. Finally, point out specifically what your company needs to do to ensure that the strategy succeeds.

Everybody knows that the future is uncertain, so also talk about ways in which your business world may be different in the future than it is today. List alternative possibilities, and in each case, describe what your company is doing to anticipate the changes and take advantage of new opportunities.

To begin to prepare for change in your business world and get help on how to think more strategically about your company's future, skip to Chapters 12, 13 and 14.

Financial review

Your financial review covers both where you stand today and where you expect to be in the future.

Describe your current financial situation by using several standard financial statements. True, these statements don't make for the liveliest reading, but the people who are interested in this part of your business plan expect to see them. The basic financial statements include:

- **Profit and loss account:** A list of numbers that adds up all the revenue that your company brings in over a month, a quarter or a year and then subtracts the total costs involved in running your business. What's left is your *bottom line* – the profit that you make during the period.

- **Balance sheet:** A snapshot of your financial condition at a particular moment, showing exactly what things your company owns, what money it owes and what your company is really worth.
- **Cash-flow statement:** A record that traces the flow of cash in and out of your company over a given period, tracking where the money comes from and where it ends up. The cash-flow statement only tracks money when you actually receive it or spend it.

Your projections about your future financial situation use exactly the same kind of financial statements. But for projections, you estimate all the numbers in the statements, based on your understanding of what's going to happen. Because nothing is certain, make sure to include all the assumptions you made to come up with your estimates in the first place.

To get a jump start on your company's financial planning, turn to Chapters 10 and 11.

Action plan

Your action plan lays out how you intend to carry out your business plan. This section should point out proposed changes in management or the organisation itself, for example, as well as new policies or procedures that you expect to put in place. Also include any additional skills that you, your managers and your employees may need to make the plan work. Finally, you want to talk a bit about how you're going to generate excitement for your business plan inside your company, so as to create a culture that supports what you're trying to accomplish. Only then can you have real confidence that your business plan is going to succeed. The key parts of the business plans should function as follows:

- The executive summary touches on all the important parts of your plan.
- The company overview describes the nature of your business, using your mission, values and vision statements.
- Your business plan should analyse your business environment.
- The company description identifies your company's specific capabilities and resources.
- The plan should discuss your current business strategy.
- A financial review includes a profit and loss account, balance sheet and cash-flow statement.

For more background on how to make your business plan work after you put it all together, go straight to Chapter 16.

Chapter 2

Charting the Proper Course

In This Chapter

- Creating your company's vision and mission statements
- Introducing goals and objectives
- Looking at business efficiency versus effectiveness
- Checking out management by objectives and management by exception
- Setting your own goals and objectives

You probably have a pretty good idea of what you want to do with your business. But how do you make your idea a reality? You start by defining the business activities that your company plans to engage in, the goals that you expect to meet and the ways in which you're going to measure success.

In this chapter, we help you create a basic overview of your company and its activities, shaping the description into your company's vision and mission statements. We introduce goals and objectives, and show you how to use them to measure the results that you expect to achieve. We also examine business efficiency versus effectiveness, as well as management by objectives, and we help you prepare to set your own company's goals and objectives.

Developing Your Company’s Vision Statement

Your business plan sets out what business you’re in or going into and how you will get there. Your plan will be reviewed as events unwind and revised as necessary from time to time. Maynard Keynes’s view that ‘when the facts change I change my mind’, may well be valid but nothing is so debilitating to customers, suppliers, employees or financial backers as a business that appears to keep changing course. A well-founded business may well tack from time to time, but the general direction of travel should be set for the longer term as set out in its vision, mission, objectives and goals.

Thinking big

A vision is about stretching the organisation’s reach beyond its grasp. Few now can see how the vision can be achieved, but all can see that it would be great if it could be. Microsoft’s vision of a computer in every home, formed when few offices had one, is one example of a vision that has nearly been reached. Stated as a company goal back in 1990, it may have raised a wry smile – after all it was only a few decades before then that IBM had estimated the entire world demand for its computers as seven! Their updated vision to ‘Create experiences that combine the magic of software with the power of Internet services across a world of devices,’ is rather less succinct! Apple, Microsoft’s arch rival, has as their vision to ‘make things that make an impact’. They do so by using the latest technology, investing in packaging and design, making their products easier to use and more elegant than anything else around and then sell them at a premium price. Personal computers, music players, smartphones and tablet computers, and now cloud-based services have all been treated to the Apple visionary touch with considerable success. In 2011, Apple overtook Microsoft in terms of its stock market value.

Ocado, the online grocer floated on the stock market in 2010, was established with a clear vision: to offer busy people an alternative to going to the super market every week. IBM's vision is to package technology for use by businesses. Starting out with punch-card tabulators, IBM adapted over its 100+ years history to supplying magnetic-tape systems, mainframes, PCs, and also with consulting, since it bought the consulting arm of PricewaterhouseCoopers, an accounting firm, in 2002. Building a business around a vision, rather than a specific product or technology, makes it easier to get employees, investors and customers to buy into a long-term commitment to a business, seeing that they may have opportunities for progression in an organisation that knows where it's going.

Using the power of passion

A vision statement not only points the way to the future, but also makes you want to get up and go there. It represents your company's best hopes and brightest dreams. Now, we know that Karl Marx and his crew seldom come up in conversation at cocktail parties any longer, even in Moscow. But when you hear his message:

> *Workers of the world, unite! You have nothing to lose but your chains!*

many find it hard not to be roused, even today. Effective vision statements are, in part, inspirational calls to action. What if

Marx had come up with something like this:

> *Hey, guys, let's all get together over here! Maybe we can figure out how to make you more dosh!*

Karl who? Forget that place in history.

> Don't panic if you don't have the makings of a dynamic, charismatic leader in your back pocket. An insightful corporate vision is much more likely to develop out of a diverse team of hard-working folks than to spring mysteriously from an inspired moment in the life of a leader. And if you wait around for the person at the top to produce something, you may never see a vision statement. Tackle the task on your own, before those above request you to, and you just may jump-start a process that's long overdue.

It shouldn't surprise you to hear that the best way to create a meaningful vision statement looks a lot like the best way to create a values statement (check out 'Putting Together the Values Statement' in Chapter 3). Just follow these steps:

1. **Select a small group of dedicated employees from various levels across your company.**

   If your company is small, get the whole gang together. If you're the chief cook and bottle washer all in one, you can represent yourself. Remember – the more people you involve, the broader the perspective and the better the chance you'll get a vision statement that truly reflects your company's future.

2. **Have the group reread your company's values statement and review the list of stakeholders who have an interest in your company.**

3. **Begin a verbal free-for-all.**

Allow everybody to add his or her own two pennies' worth and to volunteer personal opinions and ideas about the company's future form and direction.

4. **After the vision team feels comfortable with its work, add the finishing touches and send the draft upstairs.**

   If a vision statement is to take on its rightful role, it must be embraced and promoted by managers at the top.

As a rule of thumb, you should assume that your vision statement will serve the company for the next decade. Does this rule mean that you can never change the statement? No – but you should change a vision statement only if business conditions truly warrant a new course of action. Keep in mind that the ideas you captured in your company's vision statement aren't meant to be crossed out or rewritten on a whim; they represent the lasting themes that guide your company at any time and under any circumstance.

Building a brand

Brands are the ultimate form of business vision. Building a brand takes time and a considerable amount of effort to establish. Just putting a sentence into your business plan stating that you will 'create a brand image' without showing why and how you will go about it, will significantly reduce a reader's confidence in your venture. Having a brand is considered the Holy Grail when it comes to creating a unique identity for a business. By creating brand value, that is the price premium commanded by a branded product over its unbranded or less appealing competitors, a business can end up with a valuable asset.

A brand encompasses not just what a product is or does but all the elements such as logo, symbols, image, reputation and associations. McDonald's arches represent its brand as a welcoming beacon drawing customers in. Branding is an intangible way of differentiating a business in a way that captures and retains markets through loyalty to that brand. Coca-Cola tastes little different from a supermarket brand, but the promotion that supports the brand confers on the consumer the chance to share the attractive life style of those 'cool' people in the adverts. Apple's iPod is differentiated from just any old MP3 player in much the same way. Intel and Audi are examples of branding designed to reassure consumers in unfamiliar territory that a product will deliver. The Body Shop International exudes ethics and concern for the environment, where other cosmetics concentrate on how they will make the wearer look beautiful.

A brand generates trust, a fact that appears to transcend business sectors. Consumers are as loyal to Coca-Cola, Procter & Gamble and Wal-Mart as business users are to Cisco, HSBC and Goldman Sachs for a company, for its products, and for its services. According to BrandZ, consideration of brand in the purchase decision has risen by 20 percentage points since 2005. So, in uncertain economic conditions people turn to something they can trust – an established brand. For example, over the period 2005–2010 while companies in the S&P 500 lost 11.5 per cent in value, those of the top 100 brands gained 18.5 per cent.

Creating Your Company's Mission Statement

True, no one jumps up and down with excitement at the idea of a mission statement. Too many of us have seen mission statements turning yellow on the cafeteria noticeboard, completely ignored by everyone but the people who wrote them. But it doesn't have to be that way.

Your company's *mission statement* is meant to communicate the purpose of your business to people both inside and outside the organisation. It establishes who you are and what you do. To be effective, your mission statement must do the following things:

- Highlight your company's business activities, including the markets that it serves, the geographic areas that it covers and the products and services that it offers.
- Emphasise the things your company does that set it apart from every other business out there.
- Include the major accomplishments that you anticipate you will achieve over the next few years.
- Convey what you have to say in a clear, concise, informative and interesting manner (a little inspiration doesn't hurt, either).

Getting started

We know that creating a mission statement for your company can sound like an impossible task – the Mount Everest of business-planning chores. Some preparation up front, however, can make the process a little easier. Ask yourself the following background questions as you get ready to work on your company's mission statement. Don't worry if the answers are fairly general at this point, because you're only interested in the basics right now. If you feel that you need some help getting started, take a closer look at your customers in Chapters 5 and 6 and ask yourself these background questions:

- Which customers or groups of customers does your company plan to serve?
- What products or services does your company plan to provide?
- What needs do you satisfy?
- How do your company's products differ from the competition's?
- What extra value or benefits do customers receive when they choose your company over the competition?
- How fast are these answers changing?

In other words, a well-crafted mission statement answers a basic question:

What is your business?

Need more help? That's not at all surprising. To create a mission statement that's worth anything requires the involvement of managers who are familiar with all aspects of your business. Follow these steps to begin the process:

1. **Get together a small group of people whose responsibilities cover all major functions and activities that the company is involved in.**

2. **Ask the group members to prepare for this assignment by coming up with their own answers to the background questions listed earlier in this section.**
3. **Review the reasons for having a company mission in the first place, and go over what the mission statement should include.**
4. **Schedule several informal meetings in which group members can present their own perspectives, brainstorm a bit, and begin to form a consensus.**
5. **Create, revise and review the company's mission in as many formal meetings as it takes for everyone to be satisfied with the final mission statement.**

Defining your business (in 50 words or less)

Your company's mission statement has to draw a compelling picture of what your business is all about. We often refer to this picture as creating a *tangible image* of the company. We'll begin with a first stab at a mission statement:

> *Our gizmos bring unique value to people, wherever they may be.*

Now, this statement is not a bad start; it says a little something about geography and a bit about being different. But the statement is far from complete. To work toward communicating the company's activities, accomplishments and capabilities with more clarity and punch, we suggest expanding the statement as follows:

We provide the highest-quality gizmos, with unmatched value, to the global widget industry, allowing our customers to be leaders in their own fields.

This statement tells you what the company does (provide highest-quality gizmos), who it serves (global widget industry) and what sets it apart from its competitors (unmatched value, which allows customers to lead their own fields). This mission statement's energy makes it far more compelling than the earlier version.

How do real companies go about capturing their purpose clearly and concisely, in 50 words or less? The following examples provide useful insights:

Tesco (leading food retailer): We go the extra mile for customers making shopping better, simpler, cheaper in every store, in every country in which we operate. Every little helps.

Otis Elevator (a leading manufacturer of lifts): Our mission is to provide any customer a means of moving people and things up, down and sideways over short distances with higher reliability than any similar enterprise in the world.

Blooming Marvellous (provide fashionable clothes for mothers-to-be, by mail order and via the Internet): We aim to provide a wide choice of stylish, practical and good value maternity wear and children's wear, and the best in safe, innovative and stimulating nursery goods.

IBM: At IBM we strive to lead the world in the creation, development and manufacture of the industry's most advanced information technologies, including computer systems, software, networking systems, storage devices and microelectronics. We translate these advanced technologies into value for our customers through our professional solutions and services business worldwide.

International Red Cross (an international humanitarian organisation): The mission of the Red Cross is to improve the quality of human life; to enhance self-reliance and concern for others; and to help people avoid, prepare for, and cope with emergencies.

(Source: Company annual reports)

Keep these points in mind when writing a mission statement:

- A mission statement establishes what your company is and what it does.
- When you create your mission statement, involve people who represent all aspects of your business.
- Make your mission statement clear, concise, informative and interesting.

Introducing Goals and Objectives

Your mission statement is a giant step forward; in it, you articulate the purpose of your company by defining the business that you're in. But that's just the first step. Have you ever planned a holiday trip by car? Choosing the destination is essential (and often painful, especially if the children want to go mad at Alton Towers and you want to relax into the gentle pace of life at Walton-on-the-Naze). The real effort starts, however, when you begin to work out an itinerary, carefully setting up mileage goals and sightseeing objectives so that you won't see your three-week getaway turn into a *Carry On* plot. Goals and objectives are just as important to successful business planning.

We bet that you're eager to jump right in here and get on with your business plan. We'd like to take a few moments up front, however, to introduce some important ideas that you can take advantage of when you begin setting your own goals and objectives.

Using goals to manage the plan

Who needs goals, anyway? You may be the type who plans a trip by filling the camper van with petrol, stopping at the cash machine en route and flipping a coin as you head out of town. Why waste time trying to decipher a map when you're just out for the ride? Maybe your approach is fine for a quick getaway adventure, but for a company, failing to set business goals can lead to rather more serious consequences.

If your company doesn't have goals to work toward, all directions are equal, every effort is useful and any activity represents progress.

> If your business opportunities are so obvious and so overwhelming that you don't need to define a particular course of action to reach your ultimate destination, you've won the business planner's lottery. However, you're much more likely to run into one hazardous crossroad after another, and a lack of careful planning can be dangerous indeed. Here's how things can go wrong:

- The Lloyd's of London debacle, which cost most of its 32,000 names (as those providing capital to the insurance market are known) almost their entire personal wealth, resulted from a failure to create prudent financial goals and objectives across an entire industry.
- Monumental planning blunders have been partly blamed for the collapse of the previously world-class UK motorcycle industry. The failure to anticipate and react to the Japanese market entry and superior product quality was a by-product of an industry that lacked a culture of planning.

Setting business goals and objectives provides an important insurance policy for your business: the opportunity to plan a successful course of action and then keep track of progress.

Looking at goals versus objectives

After you complete a mission statement, your business goals lay out a basic itinerary for getting there. As a result, you often state those goals in terms of general business intentions. You may define your company's goals by using phrases such as 'becoming the market leader' or 'being the low-cost provider of choice'. These aims are clear enough to focus the company's activities without being so narrowly defined that they stifle creativity or limit flexibility.

Goals are broad business results that your company is absolutely committed to achieving. In working toward its goals, your company must be willing to come up with the resources – the money and the people – required to attain the intended results. The goals that you set for your company should ultimately dictate your business choices, driving decision making throughout your organisation. Goals should forge an unbreakable link between your company's actions and its mission.

Whirlpool Corporation and its Asian goal

Whirlpool Corporation is a leading manufacturer and marketer of home appliances. In a recent annual report, the company stated several business goals, including eventual market leadership in Asia. Japanese firms operating in the region have enjoyed that position for many years.

Whirlpool is organised into four regional units around the globe: North America, Europe, Latin America and Asia. All regions but Asia recently posted higher earnings. Yet rather than pursue ways to cut costs and bring its Asia earnings up, the company invested in that region, positioning itself for the future. The goal of market leadership has clearly shaped Whirlpool's behaviour as it commits resources to the area.

The company supports its Asian goal with five key objectives:

- Partnering with solid local companies.
- Positioning its brands in the region.
- Transferring best practices into the region.
- Leveraging its global scale of operations.
- Developing human resources in the region.

Whirlpool believes that it can achieve eventual market leadership in Asia by aggressively pursuing these five key objectives as a way to clarify its intentions and measure progress.

Simply setting a general goal for your company isn't the end of the story. If that goal is to be reached, your company must also provide some guidance on how to get there. So your company must follow up its goal with a series of objectives: operational statements that specify exactly what must be done to reach the goal.

Objectives are specific statements that relate directly to a particular goal; they supply the details of what must be done and when. Objectives often have numbers and dates attached to them. In every case, it should be easy to verify that you've reached a given objective. Objectives never stand alone. Outside the context of their larger goals, they've little meaning. In fact, they can be downright confusing.

The goal 'Improve employee morale', for example, is much too general without specific objectives to back it up. Yet 'Reduce employee grievances by 35 per cent over the coming year' can be misinterpreted, stated by itself. (One way to achieve this single objective may be to terminate some employees and terrorise the rest of the workforce!) When the goal and objective are taken together, however, their meaning becomes clear.

Want an easy way to keep the difference between goals and objectives straight? Remember the acronym *GOWN:* G for goals, O for objectives, W for words and N for numbers. For goals, we use *words* – sketching in the broad picture. For objectives, we use *numbers* – filling in the specific details.

If you use different definitions for goals and objectives, don't worry, you're not going crazy. What's crazy is the lack of any standard definition of terms when it comes to business planning. The important thing is to settle on the definitions that you want to use and stick with them in a consistent manner. That way, you prevent any unnecessary confusion within your company.

Sounds like we need a summary of all this:

- *Goals* are the broad results that your company is committed to achieving.
- *Objectives* are the steps that you need to take to reach your goals.
- The right goals make your company more effective. The right objectives make your company more efficient.
- By giving everybody in your company a role in setting objectives, you stand a better chance of success.

Setting Your Own Goals and Objectives

Your company's goals and objectives reflect your primary business intentions, and they determine both the itinerary and timetable for getting you there. In other words, your goals and objectives focus the company on the important work at hand and provide a mechanism for measuring your progress.

Goals and objectives are ultimately meant to make your company more efficient and effective. But how can you see to it that setting them is also as efficient and effective as it can be? Like so much of business planning, this process involves a large dose of common sense.

Guidelines for setting goals

Goals are the broad business results that your company is committed to achieving. To jump start the process of setting your company's goals, here's a useful set of guidelines:

- Determine who will be involved in setting your company's goals. Because goals are the core of your company's business, the group members should include the people who are responsible for all your major business activities. If you're going it alone in business, try to develop a core group of advisers who can meet with you periodically to set goals.
- Develop a procedure for monitoring your company's goals on a routine basis, revising or reworking them as business circumstances change.
- Create individual goals that clarify your company's business activities without limiting flexibility and creativity.
- Confirm that your company's goals, taken together, provide an effective blueprint for achieving your broad business intentions.
- Make sure that your company's stated goals are closely tied to your company's mission statement.
- Use the goals to communicate your business intentions to people both inside and outside your company.

Guidelines for setting objectives

This set of guidelines provides a useful template when your company starts to develop business objectives. Remember – objectives are the statements that fill in the details, specifying exactly how you're going to reach each of your company's goals. As much as possible, your objectives should be tied to cold, hard numbers: the number of new customers you want, for example, or products sold, or dollars earned:

- Determine who will set business objectives in your company. Objectives determine what must be done and when, and should involve every employee.
- Develop a system for setting, reviewing and managing business objectives throughout your company.
- Make sure that objectives are achievable and verifiable by including numbers and dates where appropriate.
- Create business objectives that are clearly linked to, and that advance, larger company goals.
- Confirm that your company's objectives, taken together, result in an efficient use of resources – money and people – in pursuit of broader business intentions.
- Consider using a formal method, such as management by objectives (MBO) or Investors in People (IIP) to involve everyone in your company in the continuous process of setting, reviewing and meeting business objectives. Check out the sidebar 'Investing in your staff' for a little more information on IIP.

Getting it right

We’ve said it over and over, but this sentence is so important that it deserves repeating one more time: Your company’s goals and objectives must be closely tied to your mission.

Too many companies become near-sighted and simply forget their broad business intentions when they go about the nitty-gritty work of setting goals and tying them to measurable objectives. Managers start with whatever’s close at hand. They look at employee activities and behaviour, and come up with incentives and rewards that seem to do the right thing at the moment, motivating workers toward specific (and maybe even laudable) objectives. But these types of goals and objectives tend to be near-sighted, and may be totally out of kilter with the larger aims of the company.

Suppose that a PC mail-order business finds that its margins are squeezed. As a result, the company sets objectives and offers incentive bonuses to managers who can reduce expenses by 15 per cent during the next six-month reporting period. The manager in charge of customer service, being a rational team player, mandates an immediate reduction in the average time that service reps can spend on the phone with customer inquiries. He delivers this mandate even though the company has built its reputation on helping customers with confusing software purchases, and even though the company mission says, ‘The organisation is committed to offering the best customer service in the industry.’

Hurried conversations inevitably lead to disgruntled customers. Even worse, these objectives send a clear signal to employees that efficiency and cost-cutting efforts are what really count – not customer satisfaction. If goals and objectives had taken the company's mission into account, perhaps the customer service manager would have come up with a more innovative solution – introducing an automated fax-back system, for example. By allowing customers the option of receiving faxes that answer the most common software questions, the system could have reduced calls to the service reps and enhanced service at the same time.

Investing in your staff

Investors in People sets standards of good practice for preparing and developing your employees to meet your business objectives. The development goes far beyond simple training activities. It has four main principles:

1. **Commitment:** An Investor in People is fully committed to developing its people in order to achieve its aims and objectives.

2. **Planning:** An Investor in People is clear about its aims and objectives and what its people need to do to achieve them.

3. **Action:** An Investor in People develops its people effectively in order to improve its performance.

4. **Evaluation:** An Investor in People understands the impact of its investment in people on its performance.

A series of 'indicators' are used by an external body to assess whether your company meets the IIP standards. A copy of the IIP Standard, the indicators and related publications are available from the Investors in People website at www.investorsinpeople.co.uk.

Goals with a mission

Innovex, a £50 million sales recruitment and management business operating in the health care market before its sale to Quintiles, operated throughout the UK and provided a flexible menu of sales and marketing services ranging from a long-term strategic partnership to a temporary increase in sales force headcount to hundreds of clients.

Innovex: Our Mission:

Innovex's Mission is to be the preferred provider for health sales support services in the communities we serve. Our customers will choose us because we provide high-quality, cost-effective, customer- responsive care and services.

Innovex: Long-range Strategic Goals:

- Become a £250 million diversified health care company within five years.
- Develop a market-driven organization.
- Create a quality-centred culture.
- Build value in our company by investing in our people.
- Create exceptional value for our share-holders.
- (Source: Company Business Plan).

Given the company's mission, Innovex's goals make perfect sense. By pursuing the goals of becoming market-driven and quality-centred, for example, the company understands that it will better serve customers and thus achieve part of its mission: becoming customers' preferred provider.

Avoiding the pitfalls

Setting your company's goals and objectives is really about influencing human behaviour. Goals and objectives are meant to motivate everyone in your organisation. They also see to it that everyone's activities are channelled in the same direction, with the same results in mind. Whenever human nature is involved, nothing is certain. But you can improve the odds that your actions will have the expected results by avoiding several common pitfalls as your company works on its business goals and objectives. Bear the following in mind when setting your goals and objectives:

Don't set pie-in-the-sky goals for yourself. If you don't have a prayer of achieving a goal, you may as well not bother setting it. Goals are meant to motivate; impossible goals tend to discourage. You don't want to mess up a knockout business opportunity just because you need a little more time, resources and energy.

Don't sell your organisation short. Although trying to reach too far with your goals can be dangerous, you don't want to wimp out, either. Goals often become self-fulfilling prophecies. Companies set them, attain them, and then relax – coasting along on automatic pilot – until they get around to setting new goals. If anything, try to err a bit on the high side, creating goals that will expand your organisation's capabilities. You may be surprised by the skills and expertise that you discover in your own company.

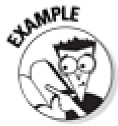
Be careful what you aim for. It's awfully important that your goals clearly state what you want to see happen. If your goals are unclear or off the mark, you and your employees may actually end up pursuing misguided aims in a determined manner. Goals that are out of sync with a company's larger mission may lead to behaviour that makes little sense from the broader perspective and purpose of the company.

Beware of too many words or too many numbers. Remember – a goal is a broad statement of a business intention that flows directly from your company's mission. Objectives are more narrowly defined and are always tied to a specific goal; they fill in the details, specify time frames, and include ways of verifying success. As we've said, goals tend to be defined in words; objectives, in numbers. But no rule is hard and fast. In reality, well-designed goals and objectives often mix words and numbers. Words alone are sometimes too vague to carry any real meaning, and not all hoped-for outcomes can be reduced to pure numbers.

Don't keep your goals and objectives a secret. If goals and objectives are meant to focus and direct your organisation's behaviour, everyone has to know about them. We know, we know – this statement seems to be so obvious that it sounds downright silly. But you'd be amazed at the number of managers and owners who carefully set goals and objectives and then go to great lengths to hide them from everyone else. They protect the goals as though they were corporate jewels. But these jewels have no value unless they're communicated to and embraced by everybody in the company.

Stretching for targets

Business plans have to be based on believable objectives and goals that have a realistic prospect of being attained. Unless they are, they will have little credibility with an outside audience. But that doesn't mean you can't dream a little. Great businesses have a base line set of objectives around which plans, resources and rewards are based with a built in proviso that achieving better than planned performance will result in better than budgeted rewards.



Jim White expanded his eco travel business slowly until two years ago when annual sales were only about £300,000. The company is staffed by travel enthusiasts. All 11 workers have three weeks of travel on the company and most use their allocation to go overseas. The result is an office that can deal with holidaymakers' queries from all over the world. After introducing a 'rewarding excellence' initiative, sales shot up by 40 per cent in just six months. The basis of the reward is an accelerating bonus. If the company hits its sales targets, staff share in a 5 per cent bonus. If it exceeds targets, the bonus rates rise too. For every 20 per cent the company achieves above target, the bonus rate goes up 1 per cent. Targets are reset each year using a similar formula but starting from a new and higher base level.

Timing is everything

What's the proper timeframe for your goals and objectives? How far out should your planning horizon be – one year, three years, maybe five? (Until the fall of communism, five-year plans were all the rage.) The answer is . . . it depends.

Certain industries remain almost tortoise-like in their pace. Many furniture companies in the UK, for example, operate today much as they did 50 years ago. Consumer tastes have changed only slowly, and the types of materials used and levels of craftsmanship required have stayed pretty much the same. Change may be on the horizon, however, with producers overseas matching style, materials and quality at significantly lower costs.

Change is perhaps the only constant for other industries. Take health care, for example. The world of doctors and hospitals was once a predictable universe in which business goals and objectives could be developed years in advance. Now the industry is going through a sea of change. Predicting where the rough waters are going to be is often an exercise in frustration. If you're in hospital management today, you're not worried about five-year horizons; your planning cycles and reviews are now more likely to be measured in months.

What change means for business planners is that you don't want to go too far out on a limb when trying to predict the future. You really have no choice but to set business goals and follow them up with verifiable objectives, but don't get into a position where you construct rigid guidelines over impossibly long time frames. Build in flexibility so that you've the opportunity to revisit your goals and objectives, trimming and tacking to avoid being capsized by all the uncertainty.

Identify the forces of change in your own industry. What are they? How fast are they moving? Chapter 4 points out how to look for opportunities and threats out there. Look at Chapter 12 for more guidance in preparing for change.

A few things to bear in mind when setting goals and objectives:

- Make sure that your company's goals are closely tied to its mission statement.
- Ambitious goals motivate; impossible goals only discourage.

- Settle on objectives that are both achievable and measurable.
- Communicate your goals and objectives to everybody in your company.

Chapter 3

Setting Off in the Right Direction

In This Chapter

- Understanding why a set of values is so important
- Figuring out who your stakeholders are
- Identifying your company's current beliefs and principles
- Putting together your company values statement

You may ask yourself why on earth you're reading a chapter on values in a book on business planning. We can hear what you're thinking: Hey, it's the twenty-first century. Today's business ethics revolve around survival in the marketplace: cater to your customers, beat the competition (hey, demolish them!), make 'loadsamoney' and run.

Yet even in a business world dominated by market economies, global competition and the laws of the jungle, values still matter. In fact, we're convinced that successful business plans must start with a statement of company values.

Now, don't get us wrong here – we have no quarrel with profits. We absolutely love them, and we expect to earn lots for ourselves over time. But short-term profits don't go far over the long haul. Values and a vision keep everybody in your company – even if you're only two people – on course and heading in the same direction. What if you're a company of one? Taking time to establish your values and vision will still keep you on track as your business grows.

In this chapter, we point out why values are so important in the first place. We help you identify your company's values by noting who has a stake in your business and discovering the beliefs and business principles that you already hold. Then we show you how to put together a values statement for your company.

Wondering Why Values Matter

Your company faces all sorts of options, alternatives and decisions every day that you're in business. If you take the time to define your company's values, these principles and beliefs can guide your managers, employees, or just you (if you're in business for yourself) as you face complicated issues that don't have easy answers. When the unexpected happens, you can react quickly and decisively, based on a clear sense of what's important.

Looking at tough choices

Consider a scenario. Frank Little is an independent consultant working for a large UK-based petrochemical firm that we'll call Bigg Oil. He's conducting market analysis for one of the company's largest divisions and is involved in an important project concerning the development of new overseas business.

Frank's good at what he does, and he sketches out several options for the production, distribution and pricing of petrochemicals in three countries. In one of his most promising scenarios, the numbers for a country that we'll call Friedonia yield substantially higher short-term profits than the other two – primarily because that nation doesn't yet have expensive pollution-control procedures in place. The other two nations have environmental laws similar to those in the UK.

Here's Frank's dilemma: by introducing its product line into Friedonia, Frank's client can make huge profits. Sure, the resulting pollution may cause ecological damage that may possibly be traced back to Bigg Oil. But this situation is not illegal, according to Friedonia's current laws, and Frank stands to get a lot more business from Bigg Oil if the project goes ahead.

He agonises over the situation and his report. What should Frank recommend to senior management:

- Go for the short-term bucks?
- Voluntarily enact procedures to control pollution, even though the company is not legally required to do so?
- Forget Friedonia until the country has stronger environmental laws?

Maybe you can relate to our friend Frank's quandary, having faced similar kinds of ethical questions and trade-offs in your own business.

If Frank had a set of values written down, those values can help him out of his quandary. Values provide a framework to guide people who are confronted with difficult choices.

Having no fundamental guidelines to follow – or, worse yet, being told to play it safe or ‘don’t rock the boat’ – businesspeople in Frank’s position are forced to choose the safest path, and that path is often determined by profits, promotion prospects or job security. But the easiest path is not always the best.

Avoiding being lost and unprepared

What happens when disaster strikes? We all remember headline-grabbing stories in which unexpected troubles tarnished the images of all sorts of companies, such as the following:

- **Exxon (oil manufacturer and exporter):** The infamous oil tanker *Valdez* spilled millions of gallons of crude oil into a pristine Alaskan bay, causing incalculable environmental damage. The TotalFinaElf tanker *Erika* did much the same off the Brittany coast in 1999.

- **Perrier (natural carbonated water bottler):** In 1989, French-based Perrier was the market leader in bottled mineral water, its name synonymous with purity and quality. Perrier water was on the tables of virtually every high-class restaurant around the world. Sales peaked at 1.2 billion bottles a year. The plant at Vergèze, near Nimes, was tooled up for 1.5 billion, with capital investment and personnel to match. The Perrier water benzene contamination incident in 1990 wiped out a lifetime investment in promoting the images of purity and quality. Coca-Cola had a similar experience when its brand of ‘pure’ bottled water, Dasani, had to be withdrawn in 2004. Far from being produced using a ‘highly sophisticated purification process’, based on NASA spacecraft technology, it turned out to be contaminated with bromate, a potentially cancer-causing chemical.

- **Intel (computer chip manufacturer):** A flaw in its Pentium chip (which was or wasn’t really significant, depending on who you talked to) led to corporate apologies and product replacement.

These companies all stumbled over so-called externalities (to use economics doublespeak). *Externalities* refer to those circumstances that extend beyond a firm’s immediate control to issues that are deeper than simply making a mint. Over time, the failure to see the power of these outside forces – and to account for social and ethical values when you make decisions – can result in serious or even disastrous consequences for your company. As the examples illustrate, we’re not talking about one unhappy customer, folks; we’re talking about big-time trouble.

Our list of examples could include episodes involving companies of every size in all industries. Faced with unexpected events, unprepared companies often react as though they’re in total disarray. When a company lacks a set of stated values that everybody subscribes to, the interpretation of important issues is left up to anyone and everyone in the company. Then the company is likely to find itself speaking with many voices and going in several directions, resulting in confused employees, unhappy customers, an angry public and maybe, disappointed investors.

Valuing having values

A *values statement* is a set of beliefs and principles that guides the activities and operations of a company, no matter what its size. The people at the top of your company must exemplify your stated values, and your company's incentive and reward systems should lead all employees to act in ways that support your company's values.

Here's an example of just how important a values statement can be. In the summer of 1985, the United States experienced what was described by many people as a terrorist attack. Someone in the Chicago area tampered with bottles of Tylenol, the best-selling pain reliever from McNeil Laboratories, a subsidiary of the health care giant Johnson & Johnson. An unknown number of Tylenol capsules were laced with cyanide, and eight people died. The tragedy created a business crisis for Johnson & Johnson.

Johnson & Johnson reacted quickly and decisively to the threat against its customers. The company pulled every bottle of Tylenol from retail shelves throughout America – a massive undertaking that ultimately cost the company more than $100 million – and it did so immediately upon learning of the problem.

When the crisis was finally over, Johnson & Johnson became a corporate role model. The company's lightning-fast response to the Tylenol incident earned it a reputation as one of the most responsible companies in the world, one that takes its civic duties seriously and is willing to put the public good ahead of its own profits. Johnson & Johnson's many businesses benefited accordingly.

Why did Johnson & Johnson behave so well when so many other companies find themselves paralysed in similar situations? The reasons are summed up in the company's statement of values, an extraordinary document called the Johnson & Johnson Credo (see the 'The Johnson & Johnson Credo' sidebar).

The Johnson & Johnson Credo

'We believe our first responsibility is to the doctors, nurses and patients, to mothers and all others who use our products and services. In meeting their needs, everything we do must be of high quality. We must constantly strive to reduce our costs in order to maintain reasonable prices. Customers' orders must be serviced promptly and accurately. Our suppliers and distributors must have an opportunity to make a fair profit.

We are responsible to our employees, the men and women who work with us throughout the world. Everyone must be considered as an individual. We must respect their dignity and recognize their merit. They must have a sense of security in their jobs. Compensation must be fair and adequate, and working conditions clean, orderly and safe. Employees must feel free to make suggestions and complaints. There must be equal opportunity for employment, development and advancement for those qualified. We must provide competent management, and their actions must be just and ethical.

We are responsible to the communities in which we live and work and to the world community as well. We must be good citizens – support good works and charities and bear our fair share of taxes. We must encourage civic improvements and better health and education. We must maintain in

> good order the property we are privileged to use, protecting the environment and natural resources.
>
> Our final responsibility is to our stockholders. Business must make a sound profit. We must experiment with new ideas. Research must be carried on, innovative programs developed and mistakes paid for. New equipment must be purchased, new facilities provided and new products launched. Reserves must be created to provide for adverse times. When we operate according to these principles, the stockholders should realize a fair return.'

For more than half a century, the credo has successfully guided behaviour and actions across the sprawling Johnson & Johnson empire, currently a $17 billion worldwide corporation employing more than 109,500 people.

MANAGER'S TIP

The Johnson & Johnson Credo works so well because each employee takes it seriously. With the active encouragement and involvement of top management, from the chairperson on down, the credo is invoked, praised and communicated throughout the company. Old-timers and new employees alike are continually reminded of the importance of the message. Promotions depend, in part, on how well managers live up to and disseminate the values of the credo within their areas of responsibility. The credo is a significant factor in Johnson & Johnson's continued performance near the top of its industry – and an indication of why the company is so well regarded by so many people.

REMEMBER

Remember the following points about values:

- A values statement is a set of beliefs and principles to guide your company's activities.
- Clearly stated values can help your company react quickly and decisively when the unexpected strikes.
- Everybody in your company must embrace the company's values.

Identifying Your Organisation's Values

Values statements often address several audiences. The Johnson & Johnson Credo (refer to the preceding section), for example, speaks to doctors, patients, customers, suppliers, distributors, employees, stockholders and the community at large. As you begin to work on your own company's values, you need to think about different groups, each of which has some relationship with your company.

Stakeholders are groups of people who have a claim or interest in how you operate your business. The stakes involved can be tangible and legally binding, or they may be informal arrangements or expectations that have developed over time. Although all these interested parties have a stake in what you do, stakeholders may have different ideas and rather strong feelings about what values your company should embrace.

You're going to put together a values statement primarily for the benefit of employees, of course (or just for yourself, if you operate a business alone). But your company's values are going to have an obvious impact on all your stakeholders, including owners, shareholders, customers, suppliers, regulators – and even your mother, if she loaned you £10,000 to start your business. As you start to identify the values that are most important to your company, you're going to have to consider different viewpoints, including the following:

- The demands of your shareholders (if you have any)
- The interests and expectations of all your stakeholders
- The beliefs and principles that you and your company already hold

In the following sections, we take a closer look at each of these factors. When you come up with a preliminary list of company values that you feel are most important, you are in a good position to go on and create a values statement.

A short values statement that works

McKinsey provide a marvellous example of a set of values that have been strongly and clearly articulated for over 60 years in such a way that any member of the professional staff who is or ever has been employed with McKinsey, anywhere in the world, can instantly, seriously and passionately tell you what the company stands for. This situation is brought about through a set of 'guiding principles':

Serving clients:

- Adhere to professional standards.
- Follow the top management approach.
- Assist the client in implementation and capability building.

- Perform consulting in cost-effective manner.

Building the firm:

- Operate as one firm.
- Maintain a meritocracy.
- Show a genuine concern for our people.
- Foster an open and non-hierarchical working atmosphere.
- Manage the firm's resources responsibly.

Being a member of the professional staff:

- Demonstrate commitment to client service.
- Strive continuously for superior quality.
- Advance the state of the art of management.
- Contribute to a spirit of partnership through teamwork and collaboration.
- Profit from the freedom and assume the responsibility associated with self- governance.
- Uphold the obligation to dissent.

Thinking about investors

Economists argue that when it comes to company values, you really have to worry about only one significant group: the shareholders. On paper, at least, the shareholders are the true owners of the firm, and they deserve your undivided attention. In this view of the world, managers are simply paid agents of those who own the company, no matter how far removed those owners may be, and you don't need to know much more about values except to carry out your shareholders' wishes.

Now, we can't really argue with this picture, as far as it goes, but it doesn't square with the intentions of many shareholders out there today. For starters, your company may not have any investors, unless you count yourself and the bank account that you wiped out to start your company. In addition, pension and mutual funds now control the majority of publicly held stocks, and the investors who buy these funds are mainly interested in making their own personal nest eggs grow. These shareholders are absentee owners. They seldom demand a serious say in management decision making. When something goes wrong with the company or with their fund, they simply sell the shares and get on with their next investment.

So what's our point? Although shareholders obviously are an important bunch, deserving the attention of companies that have shareholders, their demands shouldn't necessarily crowd out all other voices. Remember – your shareholders have the luxury of selling off shares and moving on to other choices when things go wrong. As a manager or owner, you don't have that option.

AHEAD OF THE PACK

Your company will be much better off in the long run if you take a broader view, acknowledging not just the shareholders, but also all the stakeholders, giving each group the attention that it deserves.

Considering the rest of the crew

If you think about it, you may be surprised at how many types of people are involved in what your company does – everyone from suppliers to distributors and from bankers to customers. Each group has its own set of interests and looks to your company to fulfil a series of promises. The explicit promises that you make may take the form of legal agreements, licences, freelance agreements, or purchase orders. Your implicit promises represent the unwritten expectations of the various groups that have dealings with your company.

For each group of stakeholders that you identify, ask two basic questions:

- What are these people most interested in?
- What do these people expect from my company?

In other words, what is their stake in the activities and behaviour of your company? At first glance, it may seem that your interests conflict with your stakeholders' interests. *You* may want to maximise profits over time as one of your company's key values, for example. You may decide that serving customers is important as well. But what do your *customers* want? They certainly have a stake in your business, and you're probably safe to say that they're looking for quality products and services at reasonable prices.

Do these two values conflict with each other? Not necessarily. Wouldn't most customers rather buy from companies that they trust, companies that they feel comfortable with, companies that have served them well in the past? In addition, customers don't really like the uncertainty and time wasted in trying new products or services, and they won't make a change unless they're really pushed to do so. In other words, most of your customers don't want to deny you profits, because they realise that your business – and their favourite goods and services – won't be around for long if you can't make any money. (For the lowdown on figuring out your customers, check out Chapters 5 and 6.)

At the same time, customers aren't stupid and certainly don't want to be taken advantage of. We've all heard stories about food and hardware stores that try to make a quick buck after floods, hurricanes or earthquakes. Although competition usually keeps prices in check, scarcity creates opportunity and the temptation to overcharge customers. But again, customers are stakeholders in the business, with interests and expectations. After a disaster is over and the clean-up is behind them, those same customers often take their cash elsewhere, rewarding stores that may have behaved more responsibly in the crisis.

Now you need to bring together all your information on the people who have a stake in your company and to create a stakeholder profile. Follow these steps:

1. **List all interest groups that have a relationship with your company.**

   Don't forget to include the less-obvious candidates. Your list may include customers, owners, shareholders, banks, creditors, suppliers, distributors, business partners, industry associates, regulatory agencies, advocacy groups and so on. (See Figure 3-1 for further detail.)

2. **Rank the stakeholders by importance to the business.**

   How does each group affect your business goals?

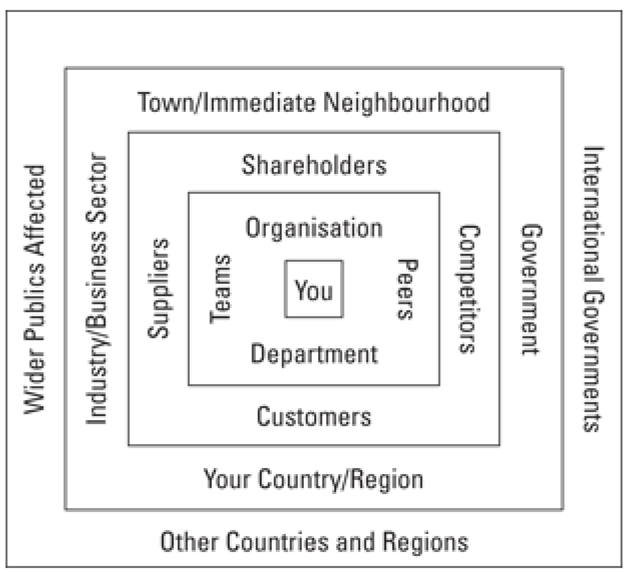
3. **Record what you think are the interests of each group.**

4. **Record what you think are the expectations of each group.**

Do your company's actions fit with what you've identified as being your key stakeholders' expectations? Always be aware of how your business decisions are perceived by the general public. How do those decisions look from the other side? Do you see satisfied customers, contented employees, helpful creditors, responsive suppliers and eager distributors? If not, how is your company going to respond to those stakeholders who feel that you're letting them down?

Ideally, of course, you want to plan ahead when it comes to your dealings with all stakeholders. The secret to responding before molehills become mountains lies in having a clear understanding of each group's expectations and a set of values that acknowledges each group's interests.

Figure 3-1: Stakeholder mapping.



Existing beliefs and principles

Drawing up a list of abstract beliefs and principles is one thing, putting those beliefs to the test is another. Tough choices come along, forcing you to examine your beliefs closely. If you run a one-person company, you already know something about what you stand for. If you're part of a bigger company, chances are that certain beliefs and values are inherent in the way in which your company does business. The best way to get to the heart of those beliefs and principles is to imagine how you'd respond to tough dilemmas.

Think about the situations described in the Beliefs and Principles Questionnaire (see Figure 3-2). Ask other people in your company, or trusted colleagues from outside your business, how they'd react to these situations. Chances are you wish that the questionnaire included a box marked *Other* or *Don't know.* But the whole point of situations that put your values to the test is that they're not always easy.

Answers to the questionnaire point to the beliefs and principles that your company's managers and employees already hold.

Keep in mind that this questionnaire has no right or wrong answers; no one's going to send a note home or give anyone a bad mark. You're simply trying to identify the basic values that your company already feels comfortable with. Completed questionnaires give insights into the general beliefs and principles that your company considers to be important.

When thinking about your company's beliefs and principles bear in mind that:

- Many people, ranging from employees to customers, have a stake in what your company does.
- Different stakeholders may have different viewpoints when it comes to your company's values.
- Your company needs to acknowledge as many stakeholder perspectives as possible.
- Company values should be tied to the beliefs and principles that you already hold.

Figure 3-2: Beliefs and Principles Questionnaire
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Beliefs and Principles Questionnaire

Situation	*Possible response*
A disgruntled customer demands a full sales refund on a product. The product isn't defective but can't be resold. The customer insists that it just doesn't work correctly. Would you be more inclined to:	❏ Send the customer away, keeping the sale on the books ❏ Refund the customer's money, absorbing the loss but betting on repeat business and loyal customers
You are faced with filling a key position in your company. Would you be more inclined to:	❏ Recruit a person from the outside who has the necessary job skills but little experience in your industry ❏ Promote an experienced and loyal employee, providing job-skills training
You are forced to let one of your employees go. Would you tend to dismiss:	❏ The young, recently hired university graduate, inexperienced but energetic ❏ The 55-year-old manager with 20 years at the company, solid and hard-working but somewhat set in his or her ways
You find out that a long-term supplier has been routinely undercharging you for services, increasing your own profit margins. Would you be inclined to:	❏ Let the matter pass, assuming that it's ultimately the supplier's mistake and responsibility ❏ Take the initiative to correct the invoice error in the future ❏ Offer to not only correct the mistake, but also pay back the accumulated difference

(continued)

Beliefs and Principles Questionnaire *Continued*

Situation	*Possible response*
You have a brilliant and creative employee. Unfortunately, this employee continually flouts the rules and disrupts the entire company. Would you tend to:	❑ Tolerate the behaviour ❑ Work on ways to correct the situation ❑ Sack the employee
An employee is faced with a personal dilemma. To meet a deadline on an important project, the employee must work overtime and miss a child's birthday celebration. Which do you tend to think of as the "better" employee:	❑ The one who willingly agrees to work overtime ❑ The one who declines to come in and instead attends the birthday party
To meet your profit target for the coming quarter, you are faced with reducing costs. Would you lean toward:	❑ Cutting back on customer-service expenses ❑ Reducing current investment in new product development ❑ Missing the quarterly target, concluding that the long-term investments are both necessary and justified
When developing the compensation packages for managers in your company, would you support:	❑ Incentives based primarily on rewarding individual effort ❑ Compensation systems that promote attainment of group or team-based goals
You discover that one of your products doesn't quite meet its published specifications. Would your likely response be to:	❑ Immediately alert your customers to the discrepancy ❑ Invest some time and effort in understanding the problem before informing customers ❑ Quietly correct the error, assuming that if customers were having problems, they would have already come to you
Rank the following in terms of their importance to you in your business:	❑ Maximise profits ❑ Satisfy customers ❑ Create jobs ❑ Promote new technologies ❑ Win product-quality awards ❑ Beat the competition ❑ Maintain long-term growth ❑ Dominate markets

Putting Together the Values Statement

When you've a good idea of just who your company's stakeholders are, and when you've got to grips with the general beliefs and principles that your company already holds, you have to bring these two worlds together. But how do you create a written statement of values based on those general beliefs and principles that also guide your company toward doing the right thing in the eyes of all your stakeholders?

First, keep in mind that your company's values statement represents more than a quick to-do list. Your values reach beyond quarterly goals or even yearly targets. They're meant to guide you through those tough decisions as you build a sustainable business that lasts and grows over years and decades.

Maybe your company already has some sort of values credo in place. If so, you're a step ahead of the game. (You lose points, however, if you have to glance at the dusty plaque on the office wall to read it.) If you can't dig up a ready-made values statement to start with, begin putting together your own. You've two options.

Developing a values statement

You may not have the luxury of spending weeks or months to develop a values statement, so we show you a quick way to create one to set your company on the right track. If your company is small, you can follow the steps yourself or with one or two of your colleagues – no need for long meetings and careful review:

1. **Meet with your company's chief decision-makers to talk about the general company values that should guide employee behaviour.**
2. **Prepare a first-draft list of all the values discussed in the meeting and circulate copies for review.**
3. **Schedule one or two follow-up meetings with senior managers to clarify and confirm a final set of values.**
4. **Create a values statement that captures the agreed-upon values clearly and concisely, and get it approved.**

5. Meet with managers at all levels to make sure that they understand the importance of, and reasoning behind, the company values statement.

6. See that every employee gets a copy of the statement.

The values statement that you come up with here may serve you well for a long time. At the very least, it should meet your needs while you work on a more complete and permanent version.

If you're part of a larger company, however, you're going to have to go through a bit more rigmarole to get a consensus. Sorry.

Make sure that every employee receives a copy of your company's values statement, along with an explanation of its purpose. If you're in business for yourself, place a framed copy of the values statement near your desk or (if you work from home) stick it on the fridge. Don't let it gather dust. For a bigger company, print the values statement on wallet-sized cards, and don't forget to include it in the annual report. Your company's values must be referred to, relied on and understood to be a guiding force in the actions and activities of every person who represents your company.

Preparing a values statement – the full Monty

Why is the quick way to create a values statement not always good enough? If you're part of a large firm, the quick way relies heavily on the ideas and suggestions of people at the top of the organisation. Yet the best insights on company values often come from employees themselves – people from different backgrounds and various levels in the company who can draw on a range of business experiences.

The long way to create a values statement takes a little more effort, but getting these employees involved usually is worth it. Follow these steps:

1. **Select three or four representative groups of employees, including a mix of people from all levels and functions in your company.**
2. **Have the groups meet on a rather formal basis over a two- to three-month period to come up with values that should guide the behaviour of every employee in the firm.**

   You have to point the groups in the right direction at the beginning. Start by asking everyone to fill out the questionnaire shown in Figure 3–2 earlier in this chapter.
3. **Ask group members to create a short list of the values that they think are most important.**

   Encourage them to back up this list with their reasons, reminding them that values are often the tiebreakers when it comes to tough management decisions and difficult choices.
4. **Bring the lists together and create a priority ranking of all the values suggested.**
5. **Compose a statement, motto, or credo that includes the most significant and widely held values, along with compelling reasons for those values.**
6. **Have the groups review and ratify your values statement.**

When the time comes to conduct those annual employee performance reviews (you know, the ones that everyone loves to hate), use them as an opportunity to promote your company's values. Bring out a copy of the values statement and ask each employee how well his or her individual activities reflect the company's values. At the same time, ask yourself whether the incentive and reward systems in your company work toward supporting those values.

Keep the following in mind when putting together a values statement:

- Even though you think that you know your values, getting them down on paper is worth the effort.
- The best insights on company values come from employees themselves.
- Make the values statement available to everybody in your company.

Part II

Sizing Up Your Marketplace

In this part . . .

The best way to succeed at anything is to figure out what you're getting into before you even start – especially the things that you can't control. Think about your garden, for example. If you plan to make that patch of dirt into a neighbourhood showcase, you have to do your gardening homework. You have to know something about the soil conditions and your climate. Is it shady or sunny? How cold does it get at night? What type of plants thrive? What combinations work well together? Which weeds do you have to watch out for? And what pests are you up against? And who said gardening was going to be easy anyway?

A business plan isn't much different. In this part we help you look out the window to see what your organisation is up against in its own backyard. The experts call this process by the important sounding title of 'research', but looking around will do just as well! First, we take a hard look at your industry or sector to see what it really takes for you to be successful. And we get you prepared for opportunities and threats that are bound to come your way. We spend a lot of time talking about the people who use your products or services - customers, consumers and clients; what they need, what they want, and what makes them happy. We look at how you can divide your customers, consumers and clients into groups with similar needs and wants, so that you can serve them even better. Finally, we talk about your competitors – who they are, what they're up to, and how you can plan to compete against them and win.

Chapter 4

Checking Out the Business Environment

In This Chapter

- Defining the business that you're really in
- Analysing your industry
- Finding out where to turn to for data
- Recognising critical success factors
- Preparing for opportunities and threats

One of the most important questions you can ask yourself as you prepare to create a business plan is 'What business am I really in?' The question may sound simple – even trivial. Maybe that's why it's too often ignored. But if you can answer this basic question correctly, you take the first giant step toward creating an effective business plan.

Remember when trains with elegant dining cars graced our railway lines? Probably not. But you can still catch an old film and become a bit nostalgic for a long-lost era. Railway companies in the 1930s, 1940s and 1950s thought that they knew exactly what business they were in: the railway business. The question was a no-brainer. As it turns out, however, passengers were looking for something a little more general: basic transportation. Railways soon found that they had to compete with motorways, Morris Motors and Ford, British Airways and international airports, finally joining forces with the likes of Virgin to run a mixture of rail and air services. The forces and players in the railway business extended well beyond ties and rails. The railways didn't see the big picture and never regained their former glory.

In this chapter, we help you capture your big picture by defining the business that you're really in. We analyse your industry, search for critical success factors and then give you pointers on preparing for the opportunities and threats that may appear on your horizon.

Ideas from some great companies

Toys R Us wants 'To be the world's greatest kids' brand'; Starbucks is 'To inspire and nurture the human spirit – one person, one cup and one neighbourhood at a time.' Neither of those missions say anything about products or services, rather they are focussed on customer groups – kids for Toys R Us and on needs for Starbucks; both are areas that are likely to be around for a while yet. Nestlé's aim is captured in these very few words: 'Good Food, Good Life'. Their claim here is to provide consumers with the best tasting, most nutritious choices in a wide range of food and beverage categories and eating occasions, from morning to night. Amazon sets out its stall by saying – 'We seek to be Earth's most customer-centric company for three primary customer sets: consumer customers, seller customers and developer customers' – though punchy enough, it might leave the rank and file with more discression than might suit everone.

Defining the Business That You're In

Okay, so what business are you *really* in? Don't say that you're in the 'widget business', if widgets are what you produce; you have to go beyond the easy answer based simply on what you do or what you make. You have to dig a bit deeper and ask yourself what makes your industry tick:

- What basic needs do you fulfil?
- What underlying forces are at work?
- What role does your company play?

You can make sure that your company isn't like the railways by understanding the underlying forces that shape your own business environment. Start by analysing the industry that you're in. For a closer look at your customers, check out Chapters 5 and 6. The competition gets a once-over in Chapter 7. And we take a closer look at your own company in Chapters 8 and 9.

Analysing Your Industry

No matter what kind of business you're in, the world around you is shaped by forces that you have to recognise, plan for and deal with to be successful over the long haul. Ivory-tower types often call this process *industry analysis*. You may have the urge to run the other way when anything having to do with analysis pops up. We don't want to sugar-coat this step, but we try to make the process as painless as possible.

The good news is that many smart people have already worked hard at analysing all sorts of industries. Although no two businesses are really the same, basic forces seem to be at work across many industries (see Figure 4-1).

The following sections describe the most important of these forces – those that are likely to be factors in your own industry – and provide hints on how you can think about these forces in terms of your own business planning.

Structure

Every industry, from flower shops to antique dealers, has its own shape and structure. The following are a few tips on what to look for.

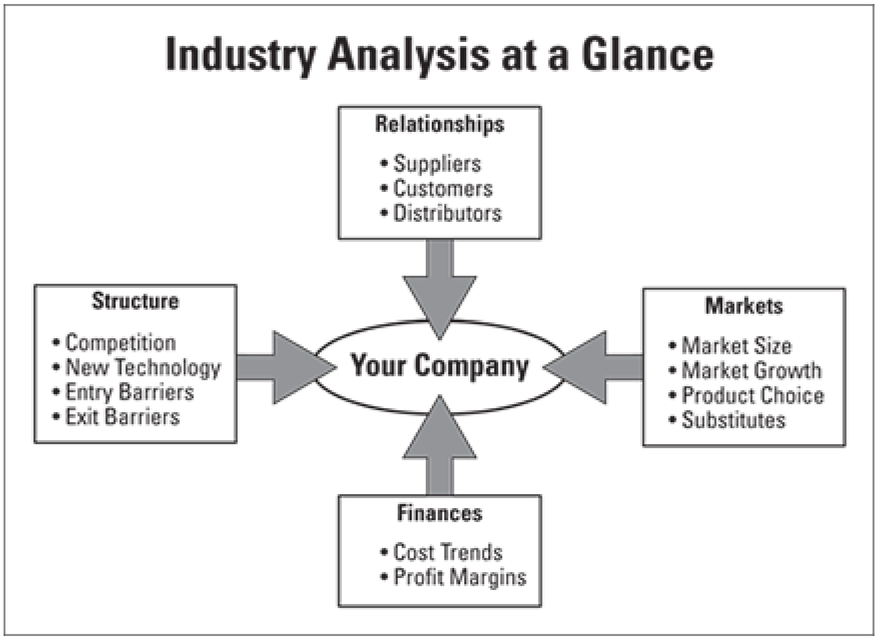
The arrangement of rivals

JARGON ALERT

The number of competitors, taken by itself, has a major impact on the shape of an industry. An industry can be a *monopoly* (one monster company with no competitors), an *oligopoly* (a small number of strong competitors), or a *multiopoly* (many viable competitors). Actually, we made up the word *multiopoly* because we figured that there should be a word to represent the vast majority of industries in this competitive world. In addition to the number of competitors, you want to check out how many of the companies are big and how many are small, as well as how they carve up the various markets that they compete in.

Figure 4-1: The four major components

of analysing
an industry.



Make a list of all the major competitors in your industry. Find out their sizes, based on revenue, profits, or some other readily available measure, and estimate their relative market shares for the markets that you're most interested in.

New technologies

Many industries are driven by changing technology. Look both at how much and how fast things are changing in your own business. Although you don't need to be a rocket scientist, you do need to feel comfortable with the underlying technological issues that fuel the change around you. You should also find out who controls the technologies and how easily the technologies can be obtained.

Identify obsolete technologies, current technology and a future technology in your own industry. How long were old technologies around before they were replaced? Try to predict when new technology may become important to your business. At the same time, try to keep track of any copyrights, patent protection, or special expertise that caninfluence the adoption of a new technology.

Can anybody play?

The cover charges that make it more or less difficult for new competitors to join the party are referred to as *entry barriers*. Some of these barriers are obvious – high capital costs (lots of money needed up-front), for example, or complex distribution systems that make it hard to reach customers. Other barriers are easy to miss. *Economies of scale,* in which the bigger you are, the more money you make, often discourage brand-new competitors. Strong customer loyalty or high customer costs associated with changing products can also create formidable barriers for new kids on the block.

As you think about your own business, list the entry barriers that you see as being obstacles to new competitors: capital costs, distribution, organisation, raw materials, new technology, scale economies, regulation, patents and customer-switching costs, for example. Then rank these barriers based on how impenetrable they really are. On which side of each barrier do you stand?

Cashing out

Sometimes, it can be hard to leave a party, even when you really want to. How difficult is it for companies in an industry to get out of the market if they want to? The ties and attachments that keep competitors around are called *exit barriers*. Exit barriers can include everything from expensive factories or specialised equipment that can't be easily sold to long-term labour contracts, extended customer leases, service agreements and government regulations.

Ask yourself how many companies have left your industry over the past five years. Try to figure out why they got out of the market and what sort of difficulties they ran into as they made their way to the exits. How many of them left voluntarily, and how many were asked to leave, penniless and in tatters?

Markets

Competition comes down to customers, and customers create markets. Ideally, the customers you're going after represent a market that's ripe for new goods or services. The following tips help you judge for yourself.

Just how big is big?

JARGON ALERT

The size of a market tells you a lot about what's likely to happen to it over time, especially when it comes to competition. Large markets, for example, are always big news and can't help but attract competitors. Smaller markets don't get the same attention, however, and because they're easily overlooked, they often represent business opportunities. You hit the real jackpot if you can turn a small market into a bigger market by discovering some sort of *usage gap* – finding a use for your product or service that no one else has thought of before.

Try to work out estimates of the overall size of your market, based on current usage patterns. Then, while you're on this subject, try your luck at coming up with novel approaches or applications that have the potential to redefine your market. Just for fun, make some market projections based on the new uses that you're thinking about.

Growing or shrinking?

If large markets are good news, rapidly growing markets are great news, and competitors are going to come crawling out of the woodwork. A growing market offers the best odds for new players to gain a foothold and unseat the existing competition. As for markets that are shrinking, you can bet that the old competitors get leaner, meaner and more fierce. So as markets change size in either direction, the competition is likely to heat up.

Identify changes in the size of your own market over the past five years, in terms of both units sold and revenue generated. If the market is changing rapidly in either direction, look for opportunities and predict the likely effect on both the numbers and the intensity of the competition.

Choices

JARGON ALERT

A quick survey of the similarities and differences among products or services in a market measures something called *product differentiation*. If each product looks pretty much like every other product (think sugar or cement), you can bet that price is important to customers in what is known as a *commodities marketplace*. On the other hand, if each product is different and offers customers something unique or special – from laptop computers to hot little sports cars – product features are likely to determine long-term success or failure in the market.

Take a hard look at the products or services offered by the top three competitors in your market. How similar are they? In what ways are they unique? Think about what you can do to differentiate your own product so that you can compete in ways beyond simply raising or lowering price.

Something altogether different

Every once in a while, a completely new type of product or service suddenly makes its debut in a market, crashing the party, so to speak. The product usually comes out of another industry and may even be based on a different technology. The new product becomes an overnight rival for the affections of existing customers – the rise of fax machines and email to challenge overnight delivery, for example, or the appearance of video cameras to challenge still photography. The threat of *product substitution* – new products taking over existing ones – is real, especially in fast-changing, highly competitive markets.

Think about what your customers did 5, 10, or even 20 years ago. Did they use your product or a similar one back then, or did a completely different kind of product serve their needs? What about 1, 5, or 10 years from now? What types of products or services may satisfy your customers' needs? Although you can't predict the future, you can envision the possibilities.

Relationships

Business is all about connections. Connections aren't just a matter of who you know – they're about who supplies your raw materials and who distributes your product or touts your services. Connections are about who your customers are and what kind of relationships you have with them. A few tips can help you spot the key connections on which your business depends.

Supply and demand

One obvious way to think about products and services is how they're finally put together. Every company relies on outside suppliers at some stage of the assembly process, whether for basic supplies and raw materials or for entire finished components of the product itself. When outside suppliers enter the picture, the nature of what they supply – the availability, complexity and importance of that product or service to the company – often determines how much control they have over the terms of their relationship with a company. That means everything from prices and credit terms to delivery schedules.

Think about your own suppliers. Are any of them in a position to limit your access to critical components or to raise prices on you? Can you form alliances with key suppliers or enter into long-term contracts? Can you turn to alternative sources? Are any of your suppliers capable of doing what you do, transforming themselves into competitors? How can you protect yourself?

Keeping customers happy

You've probably heard the expression 'It's a buyers' market'. As an industry becomes more competitive, the balance of power naturally tends to shift toward the customer. Because they have a growing number of products to choose among, customers can afford to be finicky. As they shop around, they make demands that often include pressure to lower prices, expand service and develop new product features. A few large customers have even greater leverage as they negotiate favourable terms.

The last time that you or your competitors adjusted prices, did you raise or lower them? If you lowered prices, competitive pressures will no doubt force you to lower them again at some point. So think about other ways in which you can compete. If you raised prices, how much resistance did you encounter? Given higher prices, how easy is it for customers to do what you do for themselves, eliminating the need for your product or service altogether?

Delivering the sale

JARGON ALERT

No matter how excited customers are about a product or service, they can't buy it unless they can find it in a shop, through a catalogue, on the Internet, or at their front doors. *Distribution systems* see to it that products get where the customers are. A *distribution channel* refers to the particular path that a product takes – including wholesalers and anyone else in the middle – before it arrives in the hands of the final customer. The longer this chain, the more power the channel has when it comes to controlling prices and terms. The companies at the end of the chain have the greatest control because they have direct access to the customer.

Think about what alternatives you have in distributing your own product or service. What distribution channels seem to be most effective? Who has the power in these channels, and how is that power likely to shift? Are there ways in which you can get closer to your customers – perhaps through direct-mail campaigns or marketing through the Internet?

Finance

Finally, successful business planning depends on making sense of pounds-and-pence issues. What are the costs of doing business? What is the potential for profit? A few tips can help get you started.

The cost side

With a little effort, you can break down the overall cost of doing business into the various stages of producing a product or service, from raw material and fabrication costs to product assembly, distribution, marketing and service expenses. This cost profile is often quite similar for companies that are in the same industry. You can get a handle on how one firm can gain a cost advantage by identifying where the bulk of the costs occur in the business and then looking at ways to reduce them.

> Economies of scale come into play, for example, when major costs are fixed up-front; increasing the number of products sold automatically reduces the individual cost of each unit. (For more information on economies of scale, refer to the section 'Can anybody play?' earlier in this chapter.) *Experience curves* refer to lower costs that result from the use of new technologies, methods, or materials somewhere during the production process. (For more information on experience curves, see Chapter 13.)

Separate your business into its various stages and ask yourself where the bulk of the costs occur in your own company. Can you take any obvious actions to reduce these costs immediately or over time? How does the doubling of sales affect your unit costs? How are your competitors toying with new cost-saving ideas?

The profit motive

Industries traditionally have their own general rules when it comes to expected *profit margins* – how much money they expect to end up with after all the costs have been added up, divided by all the money that they take in. In certain industries, these profit margins remain fairly constant year after year. A look at the history of other industries, however, points to cycles of changing profitability. These cycles often reflect changing *capacity levels* – how much of a product or service an industry can actually produce and deliver. A little insight into where an industry stands along the cycles of profit margin and capacity, as well as a little insight into the direction in which the industry is heading, says a lot about the competitive pressures that may lie ahead. Here are a few industry forces to consider:

- Is your own industry one that has well-known business cycles?
- Traditionally, how long are the business cycles?
- If you've been in business for a while, have your own profit margins changed significantly over the past one, two, or five years?
- What direction do profits appear to be heading in?

- Do you think that these changes in profitability will affect the number of your competitors or the intensity of the competition over the next one to five years?

Don’t stop with our list here. No doubt we’ve missed one or two industry forces that are important and perhaps even unique to your own business situation. Spend a little extra time and creative effort on coming up with other forces as you work on your own industry analysis.

After giving some thought to your industry in terms of the many forces that are at work, put together a written portrait. If you’re stuck, imagine that someone who has no experience in your industry has come to you for advice, asking whether you can recommend a substantial investment in your industry. How would you respond? Get those arguments down on paper, and you’ve made real progress in assembling a serious industry analysis.

Researching Your Market

In many cases, you may need a little outside help as well as some hard data to support your take on how various industry forces are shaping your own business environment. Unfortunately, you can’t always get your hands on the right pieces of information to explain what makes your industry tick.

Sometimes, you just can’t get the data. Maybe no one’s bothered to collect and look at it, or perhaps companies aren’t willing to part with it because they don’t want outsiders (including potential competitors) to analyse the industry too carefully. Most of the time, however, too much data is available, and the problem becomes knowing where to turn for the information that you need.

Establishing your knowledge gaps

Start by working your way through the market knowledge checklist in Figure 4-2. This checklist gives you a good idea of where to concentrate your research efforts. Best to be totally honest here and don't be afraid to fill up the right- hand column with ideas for getting at the facts. You can find tips in this chapter to arm you with the basic tools and resources to top up your knowledge base. These tools you can put to work in and chapters 5, 6 and 7 where we look in detail at getting to grips with customers and competitors.

Filling in your market knowledge gaps requires using just two fundamental tools; desk research, where you're uncovering data that someone else has already gathered and made available in some form or other, also known as secondary data; and field research, where you or someone you employ has to get out and create the information.

Carrying out desk research

You can find an increasing amount of secondary data available in published form and accessible online or via business sections of public libraries throughout the UK to enable business planners both to quantify the size of market sectors they're entering and to determine trends and competitive forces at work in those markets.

Figure 4-2: Market knowledge checklist.

Industry Competition				Know the facts/ Plan for getting knowledge
Number of competitors	Lots	⟷	Few	
Market share of top three companies	75%+	⟷	25%–	
Easy market to get into	Very	⟷	Hard	
Strong brand loyalty	Yes	⟷	No	
Easy market to get out of	Yes	⟷	No	
Competitors financially stronger	Yes	⟷	No	
Buyer Power				
Number of potential customers	Lots	⟷	Few	
Market share of top three customers	75%+	⟷	25%–	
Price sensitivity	Highly	⟷	No	
Buyer likely to move into your field	Yes	⟷	No	
Threat of Substitutes				
Hard for customers to switch products	Yes	⟷	No	
Cheaper alternatives on the market	Yes	⟷	No	
Better quality products around	Yes	⟷	No	
Better performing products out there	Yes	⟷	No	
Threat of New Entrants				
Economies of scale make it hard	Yes	⟷	No	
Capital intensive so tough to get going	Yes	⟷	No	
Brand loyalty locks the market	Yes	⟷	No	
Regulations make entry difficult	Yes	⟷	No	
Access to marketing channels limited	Yes	⟷	No	
Intellectual property restricts access	Yes	⟷	No	
Supplier Power				
Market share of top three suppliers	75%+	⟷	25%–	
Suppliers are bigger than their customers	Yes	⟷	No	
We would be unimportant to suppliers	Yes	⟷	No	
Suppliers could move easily into our field	Yes	⟷	No	
Rivalry General Factors				
Our market is growing annually by	10%+	⟷	–5%	
Technology is changing our industry	Fast	⟷	Slow	
Generally costs in your industry are rising	Fast	⟷	Slow	
Profit margins in your industry are	Strong	⟷	Weak	
There is a large untapped market to go at	Yes	⟷	No	

The good news is that technology can help rescue you from information overload. You can control the recent explosion of business- and industry-related data by taking advantage of Internet-based services and online systems that are designed to search for information that you can actually use.

The following are a few suggestions on places where you can turn for help on industry analysis. Many of the sources listed are accessible through your computer; new ones come online every day. If you've access to the Internet, start your search there:

- **Government sources:** UK government agencies at all levels provide a wealth of data free for the asking. Start with the Business Link website at www.businesslink.org, which should put you on the right track. Check out Companies House (www.companieshouse.co.uk), the Intellectual Property Office (www.ipo.gov.uk) and National Statistics (www.statistics.gov.uk). The National Statistics website contains a vast range of official UK statistics and information about statistics, which can be accessed and downloaded for free.
- **Trade associations:** You can find out more about trade associations and the information they provide online, via the Trade Association Forum (www.taforum.org), the directory of Trade Associations. On this website are links to industry relevant online research sources. For example, you find The Baby Products Association listed, at whose website you can find details of the 238 companies operating in the sector, with their contact details. The second route is to visit your local reference

library and look at a hard copy of one of these directories.

- **Libraries:** You can find thousands of libraries in the UK and tens of thousands elsewhere in the world, that between them contain more desk research data that any entrepreneur canever require.

  Apart from public libraries, you can also find hundreds of university libraries, specialist science and technology libraries and government collections of data, which can be accessed with little difficulty.

  Librarians are trained, among other things, to archive and retrieve information and data from their own libraries and increasingly from Internet data sources. As such, they represent an invaluable resource that entrepreneurs should tap into early in the research process.

  Start withThe British Library Business & IP Centre (www.bl.uk/bipc/#) of the British Library located at 96 Euston Road, London NW1 2DB; phone: 020 7412 7901.

  The information is practical rather than theoretical in nature. It is particularly useful for company news and financials, competitor information and market research including trends and statistics.

  The Internet Public Library (www.ipl.org), run by a consortium of American Universities, provides Internet users with help finding information online. This library has an extensive section on business covering most areas.

- **Online Newspapers** (www.onlinenewspapers.com). Newspapers and magazines are a source of considerable information on companies, markets and products. Virtually every online newspaper in the world is listed at

Online Newspapers. You can search straight from the home page, by continent or county. You can also find the 50 most popular online newspapers from a link in the top centre of the home page.

- **Colleges and universities:** In addition to offering library resources, business schools often offer flesh-and-blood business experts. These people are paid to analyse things, and every once in a while they come up with a valuable insight or a really good idea. If you run across an expert in your own industry, paying him or her a visit may be worthwhile. You may even be able to get students on business degree programmes to carry out some of this research for you at a fairly nominal cost.
- **Online data providers:** A growing number of companies specialise in providing business- and industry-related data at your fingertips. Kelly's (www.kellys.co.uk), Dun & Bradstreet (www.dnb.com), Kompass (www.kompass.com), Key Note (www.keynote.co.uk), Mintel (www.mintel.com) and Jordan's (www.jordans.co.uk) have all been in this business for some time, and growth of the Internet has expanded their ranks. The information usually isn't free, but it can be worth the investment. Look for first-time user offers or special promotions.
- **Direct industry contacts:** Go right to the source, if you can. Useful information can come from anywhere, including companies' public relations departments, industry suppliers, distributors and salespeople. You can also find information at industry conventions, trade shows and even factory tours.

Getting into the field

This entails getting out and finding out essential facts that have not been uncovered by desk research, because the data hasn't been collected, or because it is deficient in some important respect. Often you find that while general market information is available, say for a baker, the national information on organic bread, but not for a particular town or region. Also when the economic climate changes, say from boom to bust, buying patterns may shift quite suddenly so making desk research irrelevant.

The following are the most common methods of carrying out desk research:

- **Interviews:** Talking and listening to people is the most basic and the most used method of conducting qualitative research. Interviews differ from surveys, for example, in that they adhere less to a fixed set of questions but continually probe and cross-check information building cumulatively on the knowledge gained from earlier answers. Nevertheless, interviewers at some point have to ask the questions that give them the specific data they need. Good interpersonal skills, sensitivity to the respondent and conducting the interviews at an appropriate time and place are vital to successful interviewing.
- **Surveys:** The most common field research method is the survey. This tool is a near ubiquitous one used in organisations to get a handle on almost every aspect from measuring market potential, assessing customer satisfaction to getting the views on almost any issue surrounding a product or services. Around half of all surveys are conducted face to face, considered best for tackling consumer markets. Next in popularity come telephone, email and web surveys, which work well with companies and organisations. Postal surveys, which

used to be popular, now account for less than 10 per cent of survey work.

- **Observation:** This method involves watching what people actually do. The power of observation as a method of gathering data lies in the inconsistency between what people may say in an interview, or on a questionnaire, and what they actually do. People aren't necessarily lying, but sometimes their capacity for self deception is high. Customers may feel foolish admitting they have difficulty understanding how to use a product or service and so do not record this fact. That doesn't mean that they don't have a problem and that a company would gain valuable information from finding out about it.

Check out companies such as Free Online Surveys (http://free-online-surveys.co.uk) and Zoomerang (www.zoomerang.com) who provide software that lets you carry out online surveys and analyse the data quickly. Most of these organisations offer free trials and Zoomerang, for example, lets you ask up to 30 questions, collect 100 responses and analyse the data. After that, unlimited surveys cost around £250 a year.

Using the Internet – wisely

The Internet is a rich source of market data, much of it free and immediately available. But you can't always be certain that the information is reliable or free of bias as it can be difficult if not impossible to always work out who exactly is providing it. That being said, you can get valuable pointers as to whether or not what you plan to sell has a market, how big that market is and who else trades in that space. The following sources should be your starting point:

- Google Trends (www.google.co.uk/trends) provides a snapshot on what the world is most interested in at any one moment. For example, if you're thinking of starting a business selling clothes for kids, entering 'clothes for kids' into the search pane produces a snazzy graph showing how interest measured by the number of searches is growing (or contracting) since January 2004 when they started collecting the data. You can also see that Dublin has the greatest interest, closely followed by Poplar, in London. You can tweak the graph to show seasonality, thus showing that 'demand' peaks in November and bottoms out in January – the Christmas effect.
- Google News (www.google.com), which you can tap into by selecting 'News' on the horizontal menu at the top of the page under the Google banner. Here, you can find links to any newspaper article anywhere in the world covering a particular topic. Asking for information on baby clothes reveals recent articles on how much the average family spends on baby clothes, the launch of a thrift store specialising in second-hand bay clothes and the lauch of an Organic baby clothes catalogue.
- Microsoft (http://adlab.microsoft.com/Audience-Intelligence.aspx) is testing a product that can give you mass of data on market demographics (age, sex, income and so on), purchase intentions and a search funnel tool that helps you understand how your market searches the Internet. Using the demographics tool you can find that 76 per cent of people showing an interest in baby clothes are female and, surprisingly, 24 per cent are male. The peak age group is the 25–34 year olds and the lowest is the under 18s, followed by the over 50s.

- Blogs are sites where people, informed and ignorant, converse about a particular topic. The information on blogs is more ‘straw in the wind’ than fact. Globe of Blogs (www.globeofblogs.com) claims to be the first comprehensive world weblog directory. This site links up to over 60,500 blogs, searchable by country, topic and about any other criteria you care to name. Google (http://blogsearch.google.com) is also a search engine to the world’s blogs.

Be sure to keep these points in mind:

- Your business plan must take into account the major forces that are at work in your industry.
- The number and size of your competitors shape the structure of your industry.
- How big your market is and how fast that market is growing determine how fierce your competition will be.
- How well your business works depends on your relationships with suppliers, customers and distributors.
- If you want your company to be successful, you have to keep costs down and profits up.
- You can find loads of good industry data on the Internet.

Recognising Critical Success Factors

If you spend some quality time working on an industry analysis, the time spent should reward you with a fairly complete picture of the major forces that are at work in your business: the basic structure of your industry; your core markets; key relationships with suppliers, customers and distributors; costs and changing profit margins. The analysis can also point out trends in your industry and show you where your company is in terms of general industry and business cycles.

This analysis is all well and good. But how do you go about interpreting this industry landscape so that you can use it to improve your own business planning? Just for fun, take a moment to think about your industry as a great whitewater river. Imagine the many forces that you've listed as being the swift currents, dangerous rapids and even whirlpools in that river. You're in the company canoe. You have to do more than just point out these features and paddle merrily along; it's your job to navigate the hazards. As any whitewater expert can tell you, this navigation means figuring out what needs to be done at every turn – what special skills, resources and lines of communication need to be in place for you to survive and conquer each stretch of river.

Back on dry land, take a fresh look at your industry analysis. Ask yourself what your company must do to succeed in the face of each powerful force that you identify. Again, what special skills, organisation and resources need to be in place for you to survive and conquer? In the business world, these assets are known as *critical success factors* (*CSFs*). Critical success factors are the fundamental conditions that absolutely, positively have to be satisfied if a company's going to win in the marketplace. These factors are different for every industry because they depend so directly on the particular forces that are at work in each industry.

The critical success factors for your company are going to be rather specific – a one-of-a-kind set of conditions based on your industry analysis and the forces that you see shaping your business. You probably don't want to juggle more than three or four CSFs at any one time. But no matter how many factors you identify as being important, odds are that your CSFs fall into several general categories that you can identify ahead of time. Below, we provide a starting point for creating your own CSF list.

Technology

When jet engines became available in the late 1950s, it quickly became apparent that commercial airlines had to adopt this technology if they were to remain competitive. Jet-engine technology became a CSF for players in the industry. If you (or your children) fly jets by using computer simulators, you already know that the adoption of faster processors and speedier algorithms is just as important for success in the game-software industry. Small businesses can also leverage a new technology such as the Internet as a CSF by creating snazzy home pages.

Manufacturing

For commodity products such as steel or oil, large-scale mills or refineries are often the critical factors that lead to low-cost production and the capability to compete on price. In high-tech industries, on the other hand, automation and efficient 'clean rooms' may be the critical ingredients that allow the production of competitively priced consumer electronics products: CD players, video cameras, mobile phones and so on.

Operations

To stay ahead, companies need to generate innovation, organise production, collaborate with other companies and manage the performance of activities, processes, resources and control systems used to deliver goods and services. Operations Management is the catch all title used to hold all these disparate fields together.

> In 2008, IBM completed a major overhaul of its operations and for the first time in its century-long history created an Integrated Supply Chain (ISC) – a centralised worldwide approach to deciding what to do itself, what to buy in and where to buy in from. Suppliers were halved from 66,000 to 33,000; and support locations were reduced from 300 to 3 global centres: Bangalore, Budapest and Shanghai. The company also reduced its manufacturing sites from 15 to 9, all 'globally enabled' in that they can make almost any of its products at each plant and deliver them anywhere in the world. In the process, IBM has lowered operating costs by more than $4 billion a year.

Human resources

Consulting firms usually recruit only at the top business schools, because what they're selling is the expertise of their consultants, and clients often equate skill with educational background. In the same way, software companies really are nothing more than the total of the creativity and expertise of their programmers. In each case, people themselves are the CSF.

Organisation

The long-term success of film companies that consistently produce hits and make money often hinges on logistics – the capability to evaluate, organise and manage independent writers, actors, site scouts and production companies, as well as the media and distribution outlets. In the health care industry, health care trusts are often successful because they're good at record-keeping, efficiently steering doctors, patients, medical supplies, drugs and insurance claims through the system. Even a family-run video rental shop can gain an advantage by offering a quick, easy-to-use inventory of what's available and a system for reserving the hottest new films.

Services

Businesses that offer services of one kind or another sell rather abstract products that can't be held or touched and are difficult to copyright or patent. Success often goes to those service companies that are first in the market and work hard to cultivate a following of loyal customers. ACAs (Associates of the Institute of Chartered Accountants) and accounting firms, for example, build impeccable reputations one step at a time. A major reason why clients come to them for financial advice in the first place is simply that they're known to be trustworthy.

Location

It's no coincidence that profitable mills tend to be located in agricultural areas and that brickworks crop up near rock quarries because transportation of the raw materials is so costly. But transportation costs are not the only reason why location matters. At the other end of the spectrum, fast-food restaurants and petrol stations also live or die based on their locations. By far the most important success factor for these businesses is nabbing just the right spot along a heavily travelled route.

Marketing

Manufacturers of cosmetics, clothing, perfume and, particularly, trainers all sell hype as much as they do the physical products themselves. In these cases, critical success factors have most to do with the ability of companies to create and maintain strong brand images. Their customers are buying the name, the logo, or the label first and only then the lipstick, jeans or trainers that are attached.

Distribution

Packaged foods, household products, snacks and beverages often sink or swim depending on how much shelf space they're allotted at the supermarket or local grocery shop. A successful packaged-goods company works hard to create incentives for everyone in the delivery chain, from the driver to the grocer, to make sure that the shelves have plenty of room for its own brands, even squeezing out competing products. Speed of delivery can also be a critical success factor sometimes, especially when freshness matters.

Government regulation

Companies that contract directly with public agencies, such as waste-management firms and construction companies, often succeed because of their unique ability to deal directly with bureaucrats and elected officials. But government regulation plays a role in many industries, and the ability to navigate a regulatory sea is often the critical factor in a company's success. Pharmaceutical companies, for example, invest huge amounts of money in developing new drugs, and they stake all their potential profits and success on their skill in shepherding those drugs through the Licensing Authority's complex regulatory approval process.

One last thing before you start preparing your own CSF list: CSFs determine which companies are likely to succeed over the long haul in a given industry and marketplace. Unfortunately, CSFs are not always the same as your company's current capabilities. Chapter 8 talks more about your company's specific capabilities and how you can make sure that they reflect the CSFs that you come up with.

A few things to bear in mind about CSFs:

- Critical success factors (CSFs) are the skills and resources that you absolutely, positively must have to win.
- CSFs may include the coolest technology, the friendliest service, dynamite marketing or location, location, location.
- Keep your own list of CSFs manageable; aim for no more than four.

Outsourcing

Outsourcing involves contracting out some elements of a business's operations. Obvious advantages exist in outsourcing; the best people can do what they're best at. Quality control, however, is one strategic issue to keep in mind when it comes to outsourcing. Also an emerging danger is the arrival of the 'socially minded customer'. These customers are looking more closely at companies and their products before buying from them. So, for example, getting garments made cheaply by child labour in a third world country may make sense looked at only from an an accounting perspective but it cando untold damage in terms of adverse PR if pay and conditions are poor. While outsourcing plays a vital role in a businesses operations, it still has to be managed and to conform with corporate ethical standards.

You can read up on the sorts of activities a business can outsource, how to chose outsourcing partners and how to draw up a supply agreement with outsource suppliers at the Business Link site (www.businesslink.gov.uk). Search for 'outsourcing' using the Search field.

Preparing for Opportunities and Threats

When you've a handle on the major forces that shape your industry and can point out the CSFs that really determine what kind of company has the best shot at coming out on top, you can look ahead. Using everything that you've discovered about how your industry works, what possibilities do you see for your company, and where do the obstacles lie?

These kinds of questions often come under the umbrella of something called *situation analysis*. When you think about it, your company's situation depends partly on things that are inside your organisation (call them your strengths and weaknesses) and partly on things that happen outside (opportunities and threats).

For the moment, we're going to concentrate on the opportunities and threats that you face. (Turn to Chapter 8 to work on your own strengths and weaknesses.) Opportunities and threats come from the forces, issues, trends and events that are beyond your control as a manager. But they represent the challenges that your company has to tackle if you want to beat the competition.

It's a beautiful morning

Opportunities don't always knock; sometimes you have to find the door yourself and know when to open it. Consider the following situations. They can all lead to opportunities, so see whether any of them generate new possibilities in your own industry:

- **Major shifts in technology:** When technologies change, companies are often slow to pick up on what's new because they have so much invested in what's old. From better software products based on new operating systems to more efficient steel production using new blast-furnace technology, business opportunities present themselves.

- **Availability of new materials:** New-materials science can lead to innovative products and expanded market opportunities. The DuPont Corporation, for example, developed a chemical treatment that protects fibres from discoloration; then it created a new kind of carpet and its own StainMaster line.

- **New customer categories:** New market opportunities are born when you identify groups of customers who aren't satisfied with what's available. Renault discovered that young families following a more active lifestyle want something bigger and more comfortable than a basic saloon car, and the people-carrier market was born. In the agriculture industry, small, innovative growers around the country are rushing to fill the growing demand for organic produce.
- **Sudden spurts in market growth:** When a market suddenly takes off, opportunity passes to the companies that are first to gear up production to satisfy the growing demand. Nike, for example, has been able to sprint out in front by meeting the phenomenal jump in demand for every type of athletic shoe imaginable.
- **New uses for old products:** Growth markets also spring up when new uses are found for old products. Mobile phones used to be for top executives and emergency purposes only; now they're accessories for teenagers. Teenagers can't afford lots of mobile phone calls but can't bear to be out of touch, so they text one another by the minute. Texting has become a major new use for the mobile phone, opening up major new markets – teenagers and sub-teenagers.
- **Access to highly skilled people:** In many industries, skills are scarce and valuable resources. Business opportunities often arise when skilled workers become available. From aerospace engineers in Southern California to programmers in India and scientists in Russia, companies take advantage of any sudden expansion of the talent pool.
- **Additional locations:** Location means business. At one time, shunned by shopping centres, cinemas are being

sought out as important magnets to attract additional shoppers. Entertainment complexes in shopping centres now represent a major percentage of the cinema screens across the country.

- **Fresh organisation models:** New ways of doing business represent business opportunities in themselves. The urge to downsize, for example, has led to the outsourcing of all sorts of functions to other companies that now do nothing but manage computer systems, supply training programmes, or produce corporate newsletters for their clients.
- **New distribution channels:** There's really nothing more exciting in the business world than finding a new way to get to customers. Distribution creates a market, whether a mega-discount store or a direct telephone marketing campaign. The phenomenal growth of the Internet is based on its promise of being an efficient, effective way to reach customers with all sorts of products and services.
- **Changing laws or regulations:** The government has had a great deal to do with the way that UK companies operate and make money in all sorts of industries. In particular, deregulation has provided tremendous opportunities for rail operators, utilities such as water and gas, airlines, telephone companies and television and radio stations.

Dark clouds on the horizon

Business is risk. We can't take credit for recognising that fact, but thi statement is certainly worth repeating. For every big opportunity in an industry, you can also find an equally powerful threat to challenge the way in which things are currently done. Consider the following examples, all of which resulted in major problems for companies that didn't see the threat or didn't heed the warning signs. See whether any of these lessons apply to your own industry:

- **Market slowdowns:** A shrinking market, predicted or unforeseen, takes its toll. Excess capacity can bring a company to its knees, whether the cause is a sudden slowdown in the sales of home computers or a projected decrease in the number of passenger jets ordered by international carriers. Often, the trick is to reduce near-term production without losing the capability to react quickly when markets finally turn around.
- **Costly legislation:** Government programmes, rules and regulations often affect the bottom line. UK businesses, large and small, must plan to comply with all sorts of agency demands, from the Health and Safety Executive (HSE) to the Office of Fair Trading (OFT) and the Inland Revenue (IR). As the saying goes, ignorance of the law is no excuse, and failure to comply can be extremely expensive in terms of both time and money.
- **Changing trends:** General population trends can have profound effects on certain marketplaces. The inevitable aging of the Baby Boomers, for example, was bound to put a damper on the growth of tropical resorts and the lifestyle popularised by Club 18–30. Club 18–30 responded with new family resorts to compete with Disney Land, Paris, as a wholesome destination.

- **New and aggressive competition:** Although new competitors usually have an uphill battle on their hands, they almost always come into a market with the advantages of energy, fresh talent and a burning desire to win. After the oil shortages of the 1970s, Japanese car companies came into the UK and US market with small, fuel-efficient cars, a serious marketing strategy and a commitment to succeed over the long haul. The rest is history.
- **Substitute products:** What happens when a gizmo comes along to replace a widget? Often, the widget company is in big trouble. The danger with substitute products is that they often seem to come out of nowhere. Smartphones have given basic mobile phones a run for their money and MP3 players are turning CDs into collectors' items.
- **Exchange-rate volatility:** Today, even a local business can be affected by global economic forces, including exchange rates. For example, when the pound is strong, it can be cheaper to buy products from abroad than from the UK. This situation has a direct effect on the competitive position of UK businesses.
- **Shortages of raw materials:** From an oil crisis to the shortage of memory chips, supply problems can threaten a business. Companies often enter into long-term contracts with their suppliers to minimise these kinds of disruptions, but extended agreements pose their own set of risks and must be carefully managed.
- **Loss of patent protection:** Creativity and intellectual property are usually protected by copyrights and patents. But patents expire, and companies have to prepare for the competition that inevitably follows. Pharmaceutical firms, for example, have had to find out

how to compete with the cheaper generic drugs that become available soon after successful prescription brands lose their patent protection.

- **Labour agreements:** Unions have a significant impact on the cost of doing business, and companies in various industries have discovered how to factor in their particular relationships with organised labour. Although union activity in general has been on the wane for many years, companies that have no union histories may have to come to terms with organised workers in the future – especially in service industries, in which long hours and few benefits are becoming the norm.
- **Laziness and complacency:** You can easily get lazy when the money starts rolling in, and the list of companies that have fallen into the complacency trap is much too long for comfort. Rover, Ford and Vauxhall fell into the trap, of course, and were beaten up by Honda, Toyota and Nissan. Likewise, Sainsbury's was dislodged from pole position by Tesco when they failed to respond to Tesco's aggressive discounting strategy.

The number of potential opportunities and threats in an industry has no end. A winning business plan should include a situation analysis that points out both the biggest opportunities and the clearest threats to your company, so that you can anticipate ways to deal with both as part of your planning process.

REMEMBER

Sounds like a summary is in order:

- Good business planners keep a sharp eye out for opportunities and threats.

- Big leaps in technology, new uses for old products and innovative ways to reach customers open opportunities for your company.
- Changing lifestyles, shrinking markets and new competitors can threaten your business.
- You can turn threats into opportunities.

If you can see turbulent times ahead, skip forward to Chapter 19 where you can bone up on the best strategies for such an economic climate.

Chapter 5

Taking a Closer Look at Customers

In This Chapter

- Checking out who your customers are
- Discovering why your customers buy . . .
- . . . And why they may not buy again!
- Finding out how your customers make choices
- Remembering the big picture
- Dealing with business customers

The most crucial part of business planning involves taking a long, hard look at customers – those you enjoy having, those you would love to land and those you would just as soon give away to some unsuspecting competitor. The stakes are high. How well you know your customers ultimately determines how successful you are. But figuring out what makes customers tick can be downright frustrating. If you've tried it before, you may be tempted to throw up your hands and leave the entire mess to the so-called experts – marketing gurus, consultants or perhaps astrologers. Don't. This chapter shows you how to better acquaint yourself with your customers so that you can offer them more value and serve them more profitably than anyone else out there.

In this chapter, we take a closer look at why customers buy your products and services in the first place by exploring their needs and motives. And we investigate how they make choices in the marketplace by examining customer perceptions and their decision-making process. Finally, we take a quick look at your customers that are actually other businesses.

Checking Out Who Your Customers Are

A fresh look at customers starts with the ones you enjoy seeing – those who regularly purchase goods or services from you. But sometimes, knowing what something is *not* can be just as important as knowing what it *is*. You can find out as much about your own business and best customers by observing the other kinds of customers out there – the customers who are difficult, the customers who are gone and the customers whom you never had.

The good customer

Good customers are the ones who bring a smile to your face, the ones you like serving, the ones who appreciate you, the ones who keep you in business. They're the customers you want to keep coming back time and again. To keep all those good customers happy, however, you may need to know more than the fact that Tom likes Chinese food, Mary has a weakness for chocolates and Harry loves red ties.

Why? Isn't simply knowing individual customers on some personal basis enough? Well, not quite. What happens if you've hundreds or even thousands of small customers, such as if you run a shop, or if your staff turnover is high as in most parts of the catering industry?

In such cases, you’ve no substitute for a good database sytem for tracking your relationship with clients and then making appropriate product or sevice offers. For example, supermarkets now analyse customer purchases and make targeted special offers based on their understanding of the customer profile. This all helps to make customers feel special and loved. Your business can measure and describe its customers in several ways:

- Track *where* your customers are, breaking them down by country, region, city or postcode.
- Figure out *who* your customers are, including their age, gender, occupation, income, education and ethnic origin.
- Discover more about *how* they live – their hobbies, favourite sports teams, restaurant choices and holiday destinations, for example.

JARGON ALERT

You’re probably a step ahead of us here and have already noticed that many of these criteria result in groups of customers that look alike. When marketing gurus divide customers into specific groups, they call them *market segments*. If you’d like to get a better handle on how to separate your own customers into market segments, check out Chapter 6.

When it comes to understanding customers, one good strategy is to find out what other businesses try to find out about their customers. Keep track of the questions that other companies ask you. Richer Sounds stores (a chain of hi-fi and home cinema retailers), for example, routinely ask for your postcode when you step up to the till. And you often find a list of personal questions on product registration forms, warranty cards and customer service mailings. Some companies even offer a small reward if you tell them something – anything – about yourself. But go easy here. Radio Shack, an American electronics retailer, began to lose a lot of goodwill when customers grew suspicious about – or just annoyed by – all the questions that their shop assistants were asking.

The bad customer

'A bad customer? Isn't that a contradiction in terms?' you ask. 'How can there be such a thing as a bad customer, especially for a customer-orientated company?' Keep in mind that your initial reaction doesn't always tell the whole story. Remember that *you* don't really define the business that you're in, your *customers* do. They place a series of demands on your company and then evaluate how well it performs against those demands.

Good customers do the following:

- Ask you to do things that you do well.
- Place value on the things that you do and are willing to pay for them.
- Challenge you to improve your skills, expand your knowledge and focus your resources.

- Take you in new directions that are consistent with your strategy and planning.

Bad customers represent the flip side. They do the following:

- Ask you to do things that you aren't equipped to do well.
- Distract you, causing you to veer away from your strategy and your business plan.
- Purchase in such small quantities that the cost of doing business with them far outweighs any revenue that they generate.
- Require so much service and attention that you can't focus your efforts on more valuable (and profitable) customers.
- Remain dissatisfied with what you do, despite all your best efforts.
- Fail to pay on time – or to pay at all!

JARGON ALERT

The pundits have come up with a principle that we can apply here: the *80/20 principle*. In this case, the rule says that if you survey all your customers, 20 per cent of them account for about 80 per cent of your business. These 20 per cent are your good customers. You obviously want to keep them – and keep them happy! But look at the other 80 per cent of your customers, and you'll probably discover a few whom you'd rather hand over to the competition.

When you analyse what you do for that 80 per cent of customers and what they do for you, these customers are often more trouble than they're worth. Their shoe styles are never in stock, and their special orders are always returned. Maybe their finances are a mess, which makes them late in paying. Still, the lure of additional revenue and more customers – or the belief that you should never say no to any customer – often keeps you involved with this group. You would be better off without these customers, though, and leaving your competitors to handle such bad business impairs their ability to compete with you for good business.

To handle bad customers, follow these steps:

1. **Figure out who they are, by establishing whether you can make a profit out of doing business with them.**
2. **Convert them into good customers, by exploring ways of turning loss-making customers into profitable ones.** For example, by putting up prices, introducing minimum order sizes or minimum drop quantities or by encouraging them to order online.
3. **Alternatively, hand them over to someone else.** If they don't accept the changes to your service that you introduce to ensure that they make you money, they will soon move on to other suppliers.

A note of caution: some of this year's bad customers may become next year's good customers. Ensure that you only divest yourself of *permanently* bad customers.

The other guy's customer

You may think that focusing on customers whom you've never had points to another sort of failure on your part, but actually, these people present an opportunity. The fact that you haven't been able to serve this group gives you a challenge: to find out what your market really thinks is important. Your competitors' customers are telling you what you're not. This information is extremely useful, especially when you're working on the big picture in the early stages of business planning, defining who you are and who you want to serve.

Unfortunately, getting information out of your competitors' customers is often an expensive proposition. You don't know them, and you don't have an ongoing relationship with them. Market research firms, of course, are always eager to work with you. These companies are willing to bring together focus groups and talk to consumers about all sorts of things that relate to your products in comparison to the competition. The catch, of course, is that their services don't come cheap.

Fortunately, you don't have to be quite this formal about the information-gathering process, at least in the initial stages. As long as you can get selected people to provide sincere answers, you probably can approximate the results of a focus-group study on your own.

Bank accounts and the 80/20 principle

A large retail bank recently undertook a comprehensive study of those customers using cheque books. The results presented a classic 80/20 situation: about 19 per cent of the bank's customers were generating 90 per cent of the total profits, back in the days when banks actually made profits that is. What was the chief characteristic of the other 81 per cent? Most of those customers had accounts with average balances of less than £250, yet they wrote lots of cheques. As a consequence, the bank was losing serious money on this customer group; internal processing costs were simply greater than the revenue generated from the use of their deposited funds.

The bank conducted further research. Obviously, not all of these account-holders were bad customers. Some of them were senior citizens, for example, and a percentage of them were new and would go on to become profitable customers over time. The bank wanted to nourish developing relationships, so it set up incentives to encourage new customers to accumulate savings in related savings accounts. But the bank also knew that many of its customers would never change and would simply remain a drain on profits. So it created hurdles to 'de-market' its less profitable customers, using a new fee structure that penalised accounts when monthly average balances fell below certain levels, unless customers maintained certain balances in savings accounts.

An acquaintance of ours used to go into supermarkets and hang around the aisles in which her company's goods were displayed. When a customer came along and picked out a competing product, she offered to buy that product from the startled shopper for more than the listed price! She would offer a minimal amount (a penny, say) and then work her way up, trying to determine the shopper's degree of loyalty to the competing brand. Finally, she would ask questions to find out why. As a reward, she paid the shopper for the price of the product when the conversation was over.

Getting to know your competitors' customers is often difficult, but not impossible. Check out these ideas:

- Spend time where customers gather. Use trade shows, user groups and industry conferences to make informal contacts and begin a dialogue with your non-customers.

- Ask pointed questions of people who choose competing products. Did they take the time to see what was available on the market? Have they even heard of your product or service? If they have, did they actually take the time to look at it? If not, why not? If so, what were their impressions?
- Really listen to what they have to say, no matter how painful. Don't get defensive when people say negative things about your company or your products.

Information about your customers is valuable, if not priceless. A consultant charges you thousands of pounds for the same information.

A few points to remember when checking out who your customers are:

- To plan effectively, find out as much about your customers as you can.
- Of all your customers, 20 per cent are likely to account for 80 per cent of your business.
- Some of your customers may actually cost you money.
- Your competitors' customers can tip you off to new opportunities.

Discovering Why Your Customers Buy

Perhaps the most difficult – and useful – question that you can answer about your customers is why they buy what they buy. What actually compels them to seek out your products or services in the marketplace? What's important to them? What are they really looking for?

Understanding needs

Why do people buy things in the first place? Psychologist types tell us that *needs fulfilment* is really at the heart of all consumer behaviour (see Figure 5-1, based on the social psychologist Abraham Maslow's famous 'Hierarchy of Needs' model). Everybody has needs and wants. When a need is discovered, it creates the motivation that drives human activity. Here's an overview of people's needs:

- Survival, at the most basic level, results in the universal need for grocery shops, carpenters and tailors.
- The urge for safety, security and stability generates the need for bank accounts, disability health insurance and home alarm systems.
- The desire for belonging and acceptance creates the need for designer-label polo shirts, members-only clubs and participation in expensive diet programmes.
- The urge to be recognised and held in esteem establishes the need for company banquets, fast cars and award plaques.
- The desire for self-achievement and fulfilment results in the need for adventure holidays, quiz shows and correspondence courses.

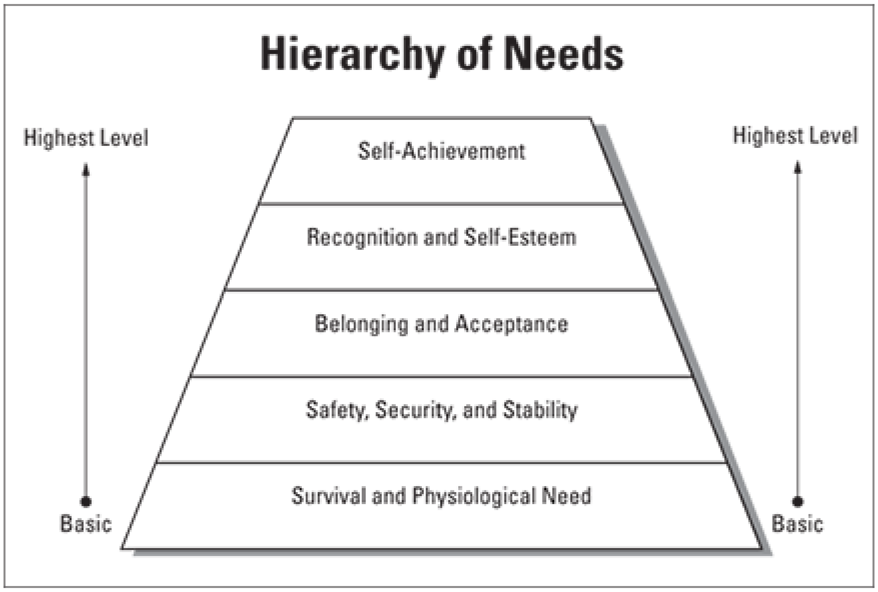
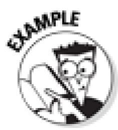


Figure 5-1: A basic overview of people's needs.



DHL, for example, is really in the reliability business. Many of its customers are businesses that want the assurance – absolutely, positively – that their precious shipments are delivered early the next day or even the same day. These customers are so motivated by this need that they're willing to pay a substantial premium over other alternatives, simply for absolute reliability and their own peace of mind.

Determining motives

Motives are needs that have been awakened and activated, so to speak. Motives send people scurrying into the marketplace, searching for products or services that can fulfil a particular need. Motives aren't always what they seem to be. Here are a few examples:

- Greeting card companies don’t just sell cute little jingles printed on glossy paper at exorbitant prices. The prices are justified because the companies are actually selling small insurance policies against their customers’ fear of feeling guilty. Perhaps fear of guilt (over a missed birthday or a forgotten anniversary) is really what propels the buyer into the greeting card market.
- Recent MBA graduates have been asked to rank the things that are most important to them when they decide among various job offers. When asked point-blank, a substantial majority rank quality of life, community and schools at the top of the list and place starting salary somewhere in the middle. A more careful survey and analysis of the MBA selection criteria, however, usually settles upon compensation as being the single most important variable in accepting a new position fresh out of university.
- Most of us have a need to be accepted and liked by other people. This powerful motivation creates great market opportunities for the likes of beauty salons, gyms and breath-mint companies.

Although motives obviously apply to individual consumers, they work equally well in the context of business or corporate behaviour. When a particular manufacturing company contracts with a private health and medical insurance company, such as Bupa, for example, is the company motivated to improve the health of its employees? Or is it motivated to reduce the cost of its health insurance premiums so that it can better compete with foreign companies (fulfilling its own need to survive)? If you run Bupa, how you answer this question has a major impact on your internal management of costs versus the overall quality of the health care that you provide.

Your job, of course, is to dig beneath the obvious customer responses and consumption patterns to determine what the buyers' real motives are in purchasing goods and services in your own market. When you understand what's actually driving customer behaviour, you're in a much better position to talk about your own product in terms that customers respond to.

Be sure to keep these points in mind:

- The most important question to ask about your customers is why they buy what they buy.
- Customer needs range from basic survival and security to the urge for self-improvement.
- Motives such as vanity, status-seeking and guilt are the hot buttons that can *really* get customers to buy.

Monitoring complaints

Discovering why your customers won't buy again is as valuable as knowing why they buy in the first place. One terrifying statistic is that 98 per cent of complaints never happen. People just don't get round to making the complaint, or worse still, they can find no one to complain to. You would have to be a hermit never to have experienced something to complain about, but just try finding someone to complain to at 8 p.m. on a Sunday at Paddington Station and you get a fair impression of how the Gobi Desert feels.

You can never be confident that just because you're not hearing complaints your customers and clients aren't dissatisfied and about to defect. Nor does silence mean that they won't run around bad mouthing you and your business to other people.

You do well to remember that on average people share their complaint with a score of others, who in turn are equally eager to share the tidings with others. The viral effect of email has the potential to make any particularly juicy story run around the world in days if not hours.

Set up a system to ensure that your customers have ample opportunity to let you know what they think about your product or service. This can involve a short questionnaire, a follow up phone call or an area on your website devoted to customer feedback. As a bonus, you will probably get great ideas on how to improve your business.

One entrepreneur who is more than aware of the problems (and incidentally opportunities) presented by complaints is Julian Richer, founder of the retail hi-fi chain, Richer Sounds. His maxim is that his staff should maximise customers’ opportunities to complain. The operative word in that sentence is *opportunities*, which should not be confused with *reasons.* In order to put this policy into effect, Richer has a range of techniques in place. The whole customer satisfaction monitoring process starts from the moment customers enter one of his retail outlets. A bell near the door invites those in the shop to ring it if they’ve had particularly good service or help while in the shop. That help may be simply getting great advice, or may be finding a product they want to buy at a very competitive price. Customers find, when they get their hi-fi equipment home, a short questionnaire on a postcard asking them for their immediate post-purchase feelings. Does the product work as specified, is it damaged in any way, were they delighted with the service they’ve had? The postcard is addressed to ‘Julian Richer, Founder’ and not, as is the case with so many other big businesses, to ‘Customer Services, Department 126754, PO Box, blah blah blah’. Richer does surveys on customer satisfaction and encourages his staff to come up with their own ideas for monitoring customer reactions. In fact, he insists that they hit minimum targets for getting customer feedback. Silence on the customer satisfaction front is not an option for management in his business. Richer is clearly aware of the other great statistic when it comes to complaining customers.

Ninety-eight per cent of customers who have a complaint buy from you again if you handle their complaint effectively and promptly. Not only do they buy from you again, but also they spread the gospel about how clever they were in getting you to respond to their complaint. Nothing makes people happier than having something to complain about that ends up costing them next to nothing.

Finding Out How Your Customers Make Choices

How do customers make choices in the marketplace? The most important thing to remember is that customers decide to buy things based on their own view of the world – their own perceptions of reality. Few customers buy without thinking. Instead, they bring their perceptions of the world into a decision-making process that (ideally) leads them to purchase your product or service instead of other options.

Realising that perceptions are reality

Customer perceptions represent the market's world view and include not only what your customers think of your products and services, but also how they see your company and view your competitors.

As customers turn to the marketplace, they confront a mind-boggling array of competing products. Many variables influence your customers as they evaluate their choices: advertising, endorsements, reviews and salesmanship, not to mention their own gut reactions. You need to know how customers respond to all these stimuli if you ultimately want to earn and keep their business.

Have you ever wondered, for example, why so few yellow jumpers are available in the men's departments of clothing shops? Market research consistently shows that a majority of men believe that the colour yellow suggests weakness. Subconsciously, men feel that they may be perceived as being wimps if they have anything to do with the colour. So the yellow-jumper option isn't too popular.

Or have you noticed that Madonna doesn't do many endorsements? Okay, she doesn't need the extra income. But companies may feel that her image is just too controversial, resulting in negative perceptions and the risk that potential buyers are driven away.

Never lose sight of the marketer's motto:

Customer perceptions are the market reality.

People buy goods and services based on what they perceive to be true, not necessarily on what you know to be the facts. To be successful in the marketplace, you have to develop a clear insight into customers' perceptions, understanding how buyers react to products and services in your market before you complete your own business plans.

Finding the five steps to adoption

Marketing gurus often refer to the customer's *decision-making process* as the *DMP* (the acronym makes the term sound more official). In many markets, the DMP involves a series of well-defined steps that are dubbed the *consumer adoption process.* (Okay, we'll call it the *CAP*.) In this case, of course, *adoption* refers to a newly formed relationship with a product, not a child.

By understanding the steps that consumers often go through, you're better able to take advantage of customers' behaviour and build strategies that help them complete the adoption process. The process involves five major steps, which are described in Table 5-1.

Suppose that you're in a startup firm with a top-notch consumer-software title. You're afraid, however, that customers are reluctant to give the program a try, for fear that the software may be difficult to fathom or incompatible with their computers. (Keep in mind that people act on their perceptions of reality rather than on the reality itself!) To move potential customers past the evaluation and into the trial step of the adoption process, you may want to consider setting up a free new-user hotline and offering a money-back, no-questions-asked guarantee.

Table 5-1 The Consumer's Five-Step Adoption Process

Primary steps	Description of consumer	Your task
Awareness	Aware of a product or service but lacking detailed knowledge	Develop a strategy that educates and excites potential customers
Interest	Curious because of publicity and seeking more information	Provide more detailed product information and continue to build momentum
Evaluation	Deciding whether to test the product or service	Make the product-evaluation process as easy and rewarding as possible
Trial	Using the product or service on a test basis	Make the trial as simple and risk-free as you can
Adoption	Deciding to become a regular user	Develop strategies to retain good customers

Sounds like we need a summary of all this:

- Customers make choices based on their perceptions, not necessarily on the facts.
- Before they buy, customers go through a distinct decision-making process.
- The five steps in making a purchase are awareness, interest, evaluation, trial and adoption.
- If you understand how customers make choices, you've a better shot at getting their business.

Remembering the Big Picture

Remember that old saying about not seeing the forest for the trees? Well, when you first start to think about your customers, you don't want to fall into a similar trap. Seeing only the small number of individual customers whom you know, and focusing on their personal habits, likes and dislikes, is tempting sometimes. Even when you begin to look at more general customer trends, including why your customers buy and how they make choices, getting buried in the details still is awfully easy.

Don't take the bait! Don't view your customers and your own business activities too narrowly. Look instead at the larger forest – those general customer behaviours and basic needs that define your market.

If you think about your business only in terms of your existing products, for example, you risk losing sight of customer needs that you've overlooked – needs that a competitor is no doubt going to satisfy at some point. You also create a short-sighted view of your own strategic choices that can result in missed market opportunities and woefully inadequate business plans.

Unfortunately, companies (and even entire industries) still lose sight of the big picture all the time. Markets are viewed too narrowly, and customer needs are neglected – a classic management blunder. Check out these examples:

- Companies that make home-improvement tools often view their business in terms of product components – the making and selling of 6mm drill bits, for example. But when you think about it, nobody really wants or needs 6mm drill bits (not even your dentist). What customers are *really* looking for are 6mm holes. That basic need creates the potential opportunity for any number of possible solutions.

- Glasses manufacturers – the companies that make the frames and lenses – continue to see themselves as being in the glasses-fashion business. But the customers, frustrated by not being able to read a menu closer than three feet away when they've forgotten their glasses, simply want to see better. The manufacturers are now discovering a hard lesson with the advent of laser technologies that promise to improve vision by reshaping the cornea – no vision problems, no need for glasses, no more business.

Politics and the marketplace

Bill Clinton had a little sign tacked up on the back wall of his 1992 US presidential campaign headquarters that read:

> *It's the economy, Stupid!*

Campaign manager James Carville posted the sign because he wanted everyone to focus not so much on the product – Mr Clinton – as on the marketplace and customer needs.

In this case, of course, the marketplace was the election itself, and the customers were the voting public. At the time, workers in the United States were suffering through a steep recession, worried about foreign competition and petrified about the 'new world economy'. As a shrewd campaign strategist, Carville knew that the road to success lay in getting beyond the candidates themselves and appealing to the voters' innermost needs – those universal, underlying issues that would ultimately sway decision making in the polling booth.

As a business planner, you have to do the same thing: focus on being market-driven when you approach your customers.

Charles Revson revolutionised the cosmetics industry when he quipped, ‘In the factory, we make cosmetics; in the store, we sell hope.’ As the founder of Revlon, he understood that he was offering his customers something far more important than simple chemistry: the prospect of youth, beauty, and sex appeal.

The key point here is simple: If you don’t know what your customers really want, you can’t possibly fulfil their needs in an effective way.

Put yourself in your customer’s shoes:

- Take a hard look at one of your own products or services, and honestly ask yourself, ‘Why would *I* need this thing?’
- Ask the same question of several people who also use your product or service.
- Try to imagine a world without your product or service. What would you substitute for it?

Answering questions such as these goes a long way toward fostering creativity, generating new strategies and providing expanded market opportunities.

Dealing with Business Customers

Although we’ve mentioned companies that sell principally to other companies (as opposed to those that sell primarily to individual consumers), some of you in this so-called *business-to-business market* may think that we’re ignoring you. We aren’t – honest! In this section, you find details on how companies, institutions and government agencies act when they themselves are the customers. What makes the business buyer different? Many things.

Sizing up secondhand demand

Demand for goods and services in business-to-business markets is almost always *derived demand*. In other words, businesses purchase only those goods and services that they can use to better serve their own customers.

Steel, for example, is a product that no end-user buys. When was the last time you had the urge to go out and get your hands on some flat-rolled sheeting? Steel purchasers tend to be car manufacturers, construction firms, appliance companies and the like. After these businesses use the steel to make their own products (cars, office blocks and refrigerators), we come into the picture as potential customers.

What are the implications for the steel sellers? If a steelmaker cuts its prices across the board, for example, should it expect a huge increase in orders? Not necessarily. The steel buyers will increase their purchases only if they think that they can sell more of the things that *they* make, and their own sales may be affected by many factors beyond the underlying price of steel. How many of us dashed out to buy a new car the last time steel prices were reduced by 10 per cent?

Inelastic demand is a term that number crunchers use when they talk about demand for a particular product that doesn't stretch or change automatically when the price of the product changes.

If you offer products or services in the business-to-business market, make sure that you take the time to think through what your planning decisions mean to your business buyers. And that means thinking about your customers' customers as well. You can do this by asking yourself:

- Does a price reduction on your part result in increased sales for your customers – and your company?
- Do your customers (and their customers) benefit if you offer them additional bells and whistles while raising their costs?
- Are your customers looking for continuity and price stability?

Thinking of decision making as a formal affair

Purchase decisions in the business-to-business marketplace tend to be more formal, rational and professional than in most consumer markets. Many people from different parts of the target company are often involved in the decision-making process (DMP). One division in the company may recommend your product or service, another may acquire it, yet another may pay for it, and all of them do the work for a separate customer centre that actually uses that product. Taken together, these divisions form the *decision-making unit* (or DMU) – another marketing term foisted off on us nice folks by marketing gurus.

Table 5-2 describes three ways in which a business DMU may behave when thinking about buying a product or service.

Table 5-2 How Businesses Behave When They Buy

Buying behaviour	Description of the customer's DMP
Business as usual	Continues to order more of the product or service, perhaps even automating the process so that inventories don't fall below certain levels
Yes, but . . .	Asks for changes in the existing sales arrangement, modifying one or more purchase terms (such as pricing, financing, quantities and options) and including various people who are part of the DMU
Opportunity knocks	Purchases a product or service for the first time, perhaps after putting out a request for proposal (RFP) to several possible suppliers and making a deliberate, complete decision involving all parties in the DMU

Judging the forces to be reckoned with

In working with business customers, you most likely have to deal with several powerful customer forces that you rarely encounter in consumer markets. If your business-to-business strategies are going to succeed over time, you must factor these forces into your business plans. Consider the following questions:

- **What's the state of the customer's business?**
  - Is the customer's business booming, mature, or dying?
  - Is it facing increased competition or enjoying record profits?
  - Is it outsourcing business, creating new opportunities?
  - Does it threaten to become a competitor?
- **How does the customer's company operate?**

    - Does the customer purchase centrally, or does it have buyers scattered around the company?
    - Does it require several levels of approval before a decision is made?
    - Do senior executives (who may or may not know a lot about the product) make the ultimate purchase decisions?
- **Who's important to whom?**
    - Do the customer's key decision makers tend to be engineers or marketing people?
    - Does the customer use both small and large suppliers?
    - Does it have a policy of requiring more than one supplier in critical areas?

As you begin to develop strategies for your business customers, take the time to investigate the forces that are unique in business-to-business markets:

- Get out into the field and talk to potential business buyers.
- Read about customers' organisations and their industries.
- Attend the conferences and conventions that your customers attend, and find out about the critical events and forces that shape their thinking.

All these activities take time and resources, of course, but your investment will be rewarded many times over when you incorporate what you discover into your business-to-business planning.

Remember the following when dealing with business customers:

- Some of your customers may be other businesses, and the way in which they buy is different from the way that individuals buy.
- Several people may be involved in making the decision to buy from you.
- Sometimes your business customers aren't the end users, so you need to understand your customers' customers as well.

Chapter 6

Dividing Customers into Groups

In This Chapter

- Defining what market segments are
- Coming up with ways to group customers
- Creating market segments that you can use
- Predicting how market segments behave

You may like to think of your customers as being flesh-and-blood people – the Tom, Dick and Mary who regularly walk through your doors. But you may also be tempted to think of customers as being everybody out there – hey, shouldn't the whole world want your products and services? Unfortunately, neither of these views is practical when it comes to creating your business plan.

Take a closer look at your customers (a good place to start is Chapter 5). One of the first things that you notice is that many of them have a great deal in common – a fact that gives you a golden opportunity to divide customers into specific groups based on their similarities. Eureka! By planning your business around these customer groups, you can serve your customers' particular needs effectively.

In this chapter, we look at your customers in groups, introducing the concept of market segments in detail. We explore various ways to identify market segments based on who is buying, what they buy and why they buy. Then we show you how to create practical market segments that you can use in your business plan. Finally, we talk about things you can do to figure out more about how market segments are behaving.

Defining Market Segments

Take a moment to think about your customers. You'd no doubt call many of them good customers, for these reasons:

- They bring in lots of business.
- They're loyal.
- They pay on time.
- They make useful suggestions.
- They say nice things about you.

These people are good customers because they're satisfied customers. You understand what they're looking for, and you translate their needs and wants into the products and services that you sell them. But face it – not every customer is a good customer, and you probably wish that you had a few more of the good ones.

Addressing each customer individually may be effective, but is rarely efficient in today's markets. How can you make sure that you satisfy as many potential customers as possible? Although each individual customer is unique, groups of customers often look a great deal alike.

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Whenever you make sense of your own marketplace by grouping customers for one reason or another, you create *market segments*. To be of any practical use in your business planning, however, market segments should describe groups of customers that you can reach and who respond to your products and services in similar ways – ways that are distinct from those of other customer groups. A successful market segment allows you to satisfy the particular needs and wants of an entire group of customers.

There was a time when trainers were rubber-soled canvas shoes that kids played in and maybe used for school sports. Back then, most of the buyers were parents, and most of the wearers were boys. If you wanted to play in the trainers market (Adidas and Hi Tech, for example, produced trainers that parents bought in droves), you kept your eye on what those boys were looking for.

Look at the market for sports shoes today. The difference is phenomenal. Young males still wear the shoes, of course, but so do toddlers, cool teenagers, serious runners, senior citizens and everyone else – all demanding trainers in various shapes and colours, with different features and options, in a wide range of prices.

Literally dozens of athletic-shoe segments exist now, each defined in unique ways. For Nike or Reebok to attempt to capture the market today with one universal trainer would be sheer folly and a financial disaster. The athletic-shoe business and the market segments that shape it have changed beyond recognition over the past two decades.

These points may help you when defining market segments:

- A market segment is a group of customers who have specific needs and wants in common.

- By grouping similar customers, you can satisfy their particular needs more efficiently.
- The more features and choices that customers demand, the more reason you have to divide customers into groups.

Extra! Extra! Cars to have options!

In the early 1920s, Henry Ford and his famous Model T dominated the growing automobile industry in the United States. As Ford was fond of saying:

> *You can get the T in any color you like – as long as it's black.*

The key to the company's early success was its focus on just one product. Ford believed that if one size could fit all, standardised parts and mass production would lead to lower costs, lower prices and satisfied customers. He was absolutely right . . . up to a point.

The market reached that point when car buyers began to develop a taste for options. Some buyers wanted to be sporty; others, classy. Some wanted more leg room; others, more room for the kids. Ford continued to improve his cars, of course. The chassis became sturdier, the engine quieter and the ride smoother. But when customers visited a Ford showroom, all that they saw was the same old Model T – still available in all shades of black.

Then along came Alfred P. Sloan, Jr., the legendary head of General Motors. Sloan's genius was in recognising that car buyers weren't all looking for the same car. He captured this vision when he said:

> *GM will produce a car for every purpose and a car for every purse.*

Sloan soon hired a new kind of employee – the market researcher – to figure out what potential car buyers were really looking for. Although he couldn't produce a unique car for each individual buyer, his market research identified five major groups of buyers with similar tastes and needs. In a bold move, he instructed his designers and engineers to come up with cars that would meet those needs. The result was a new line-up of products tied directly to market segments:

- Chevrolet for entry-level buyers
- Pontiac for buyers who were moving up
- Oldsmobile for the growing middle class
- Buick for those who wanted something finer
- Cadillac for status-seekers

GM cars soon began to outsell Fords, and market segments took their rightful place as an important business-planning technique – not only for cars, but also for major industries across the nation and the world. Sure, nothing lasts forever. All the motor companies hit the buffers in the big dowturn of 2009, but that's the central characteristic of strategy. When the world changes, so must you.

Ways to Make Market Segments

You can divide customers into groups in several common ways. But don't just rely on these. Frankly, the more you can apply your own imagination and creativity in this area, the more successful you're likely to be in coming up with market segments that are unique and effective.

Despite what the marketing gurus tell you, there's really no right or wrong way to divvy up your market. You need to view your customers from various angles and to describe them based on several factors. One dimension won't be enough. As Figure 6-1 shows, you can come up with ways to create market segments by asking three basic questions:

- Who is buying?
- What do they buy?
- Why do they buy?

Looking at who is buying

A general description of who is buying your product or service is a good place to start when you begin to put your customers into market segments. If your customers are individual consumers, find out a bit about how they live their lives. If your customers are other companies, find out how they operate their businesses. Think about your customers in these terms:

- Geography (where do they live?)
- Profile (what are they like?)
- Lifestyle (what do they do?)
- Personality (how do they act?)

Where do they live?

Perhaps the simplest and most widely used way to describe your customers is based on where they are, beginning with a simple geographic breakdown by these factors:

- Country
- Region
- City
- Postcode

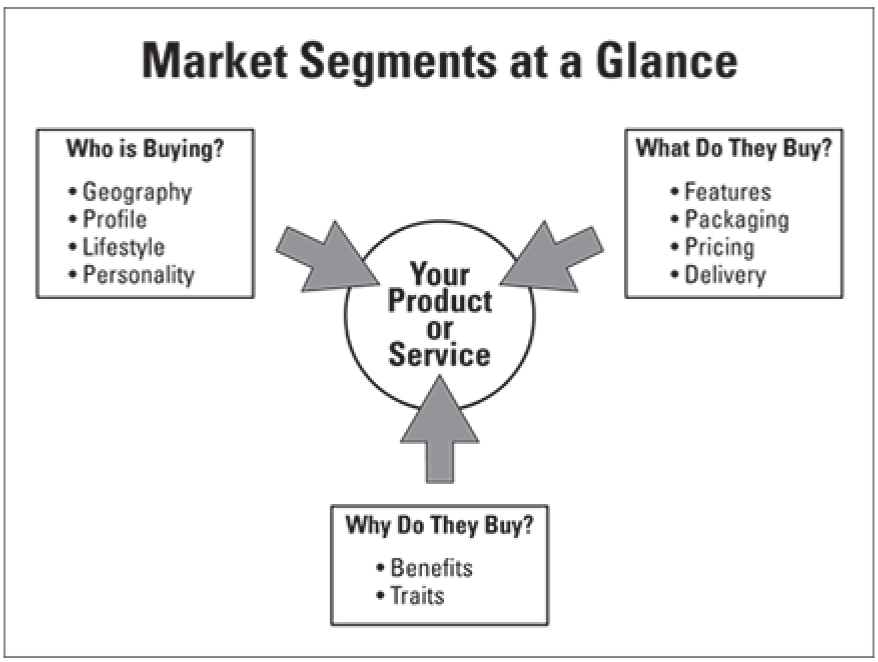

Figure 6-1: You can define market segments by asking three basic questions and then answering those questions from different market viewpoints.

But geography can also lead to more nitpicky groups, describing customers based on these factors:

- How close their nearest neighbours are.
- How hot or cool their summers are.
- How long their trips to the airport take.

Dividing customers into groups based on geography turns out to be a good way to separate them according to regional taste – which often is a significant factor in the distribution and delivery of a product or service.

Arsenal shirts, for example, don’t sell that well in Manchester.

UK electricity and gas markets regulator Ofgem reports that more UK customers are taking advantage of the right to change their electricity and gas supplier than ever before. The UK, argues Ofgem, now has the most competitive energy market in the world.

According to Ofgem’s latest figures, an average of between 30 per cent and 40 per cent of UK customers have switched their supplier, but wide regional variations exist.

What are they like?

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A profile of your customers includes all the attributes that you may expect to find in a national census. Marketing gurus call these attributes *demographic data*. These data include the following:

- Age
- Gender
- Family size
- Education
- Occupation
- Income
- Ethnicity

- Nationality
- Religion

Company profiles, of course, are somewhat different. These profiles can include basic characteristics such as the following:

- Industry
- Size of company by turnover or market valuation
- Number of employees
- Years in business

You can often use customer profiles to spot market trends and take advantage of potential opportunities. Why is the market for health care products booming today? Because the fabled Baby Boom generation – those millions who were born between 1946 and 1964 – is beginning to come face to face with its own mortality. And where can you find a growing market for financial loans? The growing number of families who have university-age children.

What do they do?

Lifestyle is an awfully tired word these days, used to describe anything and everything that we do in the modern world. But when applied to your customers, *lifestyle* has a particular meaning;the word is meant to capture characteristics that go deeper than what's available in plain old census data. Customer lifestyle factors include:

- Hobbies

- TV viewing habits
- Social activities
- Club memberships
- Holiday preferences

Barack Obama's online election winning machine

Barack Obama's strategists knew that to win the 2008 Democratic Primaries and the subsequent Presidential election in 2009 he had to capture the lion's share of the Internet-savvy market segment, a disparate group that straddled the usual political and colour divides. To help achieve this, his campaign team recruited a 24-year-old named Chris Hughes. Four years earlier Hughes had been at Harvard, and together with roommates Mark Zuckerberg and Dustin Moskovitz he helped launch Facebook. Obama's team perfected online fundraising using this social networking model and in February 2008 alone, they raised $45 million dollars of the campaign's total of $55 million online. Obama tapped into the market segment most likely to listen to his message of 'change' and pulled in their money in slugs of $25 dollars and upwards, while the Republicans stuck to traditional black-tie fundraising events.

All this information is sometimes called *psychographic data* because the information is used to map out the psychology of the customer.

Applied to business customers, lifestyle factors include such things as what companies do when it comes to the following:

- Protecting the environment.
- Donating to charitable causes.
- Investing in employee training.
- Offering employee benefits.
- Promoting people from inside the company.

You can use any of these characteristics to understand how you may better serve a particular segment of your business market.

How do they act?

Your customers are individuals who have their own ways of acting and interacting with the world. Wouldn't it be useful, however, if you could create market segments based on general personality types? Luckily, you don't have to start from scratch. Some behavioural scientists (the spooky folks who always have their eyes on us) have come up with five basic personality types, which are described in Table 6-1.

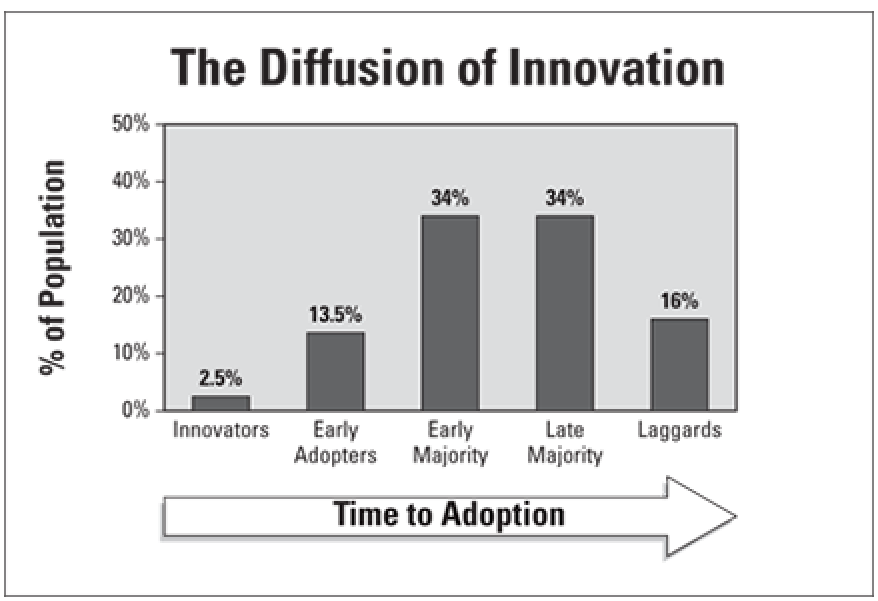
Table 6-1 Customer Personality Types

Type	Description
Innovators	Risk-takers of the world Young and well-educated Comfortable with new ideas and technologies Mobile and networked Informed by outside sources
Early Adopters	Opinion leaders in their communities Careful evaluators Open to well-reasoned arguments Respected by their peers
Early Majority	Risk avoiders whenever possible Deliberate in their actions

	Unlikely to try new products until those products catch on
Late Majority	Sceptics Extremely cautious Disappointed by other products Reluctant to try new products Respond only to pressure from friends
Laggards	Hold out until the bitter end Wait until products are old-fashioned Still hesitate!

As it turns out, personality type has a great deal to do with how eager people are to try new products and services. (Check out the consumer adoption process in Chapter 5.) Although some of us are adventurous and willing to try new things, others are quite the opposite, never using anything until it has made the rounds. In general, the laggards among us simply take longer to adopt new ideas than the innovators do. Experts make all this stuff sound like rocket science by calling it the *diffusion of innovation* (see Figure 6-2).

Figure 6-2: Product adoption occurs at different times for different personality types.



In Figure 6-2, the percentage of people who represent each personality type is just an estimate, of course. But still, you get a rough idea of the relative size of each personality group in your own marketplace.

Over the years, marketers have accumulated lots of data on the typical person in each of the five groups. You can use this information in your planning efforts. First, identify which personality types are most likely to have a positive response to your product or service. Then you can begin to assemble a description of your target customers and create a business plan that enables you to reach them efficiently and effectively.

Looking at what they buy

A description of your customers in terms of their geography, profiles, lifestyles, and personalities gets you only so far. Unfortunately, these basic characteristics don't talk about your customers in terms of your own marketplace and the products and services that you want to sell them. So you can find it hard to use these kinds of market segments to better serve your customers or provide them superior value. For that kind of help, you're going to have to look at other ways of grouping customers.

A description of customers based on what they buy enables you to view them from a perspective that you're familiar with: your own products and services. After you come up with market segments based on what your customers purchase, you can address the needs of each group by making changes in the following aspects of your product or service:

- Features

- Packaging
- Pricing
- Delivery options

What can it do?

Features refer to all the specifications and characteristics of a product or service – things that you often find listed in a product brochure, users' manual, or the small print on the packaging itself. When you group customers based on the product features that they look for, the customers themselves turn out to have a great deal in common. Their similarities include:

- How much they use the product (light, moderate, heavy).
- How skilled they are in using the product (novice, intermediate, expert).
- What they do with the product (recreation, education, business).
- What kind of customers they are (adviser, reseller, user).

Packard Bell, for example, sells low-end computers primarily to buyers who aren't technology wizards. These buyers probably use their machines at home for a few hours a week to do family finances, finish homework, surf the Internet, or just play games. Packard Bell's customers are completely different from those of Sun Microsystems, a maker of high-end workstations. Sun's customers most likely are technically trained professionals who use their computers at work for many hours each day. All you have to do is compare the features of Packard Bell computers and the Sun workstations to discover that these companies' products target two different groups of customers.

How is it sold?

Packaging involves much more than cardboard, shrink wrapping and plastic. *Packaging* really refers to everything that surrounds a product offering, including the following:

- Product advertising (radio/TV, magazines, billboards, T-shirts)
- Promotions (in-store sales, coupons, competitions)
- Marketing (book reviews, telethons, celebrity endorsements)
- Product service (warranties, helplines, service centres)

Again, the market segments that you identify based on packaging criteria often reflect customer attributes similar to the ones based on product features: frequency of use, level of sophistication, product application and type of user.

Because Packard Bell sells primarily to the home market, for example, it advertises its computers in the mass media, pre-installs all sorts of popular software titles on them and services them widely. The sophisticated Sun machines, on the other hand, are written up in computer journals, are compatible with sophisticated operating systems and are mostly serviced through on-site warranty agreements.

What does it cost?

The pricing of a particular kind of product or service is bound to create different groups of customers. Customers who are price-sensitive are in one camp; those who are willing to pay for a certain level of quality are in the other. If you've ever had to endure a course in microeconomics (yuck), you won't ever be able to forget two facts: price is a major market variable, and the price/quality trade-off is a fundamental force in every marketplace. Packard Bell computer buyers are price-sensitive, whereas the techies who buy Sun workstations are more interested in satisfying their own state-of-the-art needs.

In general, the mass market tends to be price-sensitive, and the so-called *class market* buys more on the basis of quality, high-end features and status. But price isn't the only financial factor that can lead to different market segments. Other criteria include:

- Available financing (offered by home-furnishings companies)
- Leasing options (offered to airlines that are buying planes)

- Money-back guarantees (offered regularly on TV)
- Trade-in arrangements (offered by car dealerships)

Where is it found?

Distribution and delivery determine how customers actually receive your product or service. In this case, market segments are often based on where your customers shop, such as the following:

- Warehouse stores
- Discount centres
- Department stores
- Boutiques
- Catalogues
- The Internet

Packard Bell sells a large percentage of its computers at warehouse stores such as Dixons and PC World. But you won’t find Sun workstations at those stores. Those workstations are more than likely purchased through computer resellers that specialise in high-end technology.

The Avon cosmetics company reaches its customers directly at home, using independent sales consultants, and its products aren't available in any shop. The company believes that beauty aids are personal in nature and require highly personalised selling to be successful. With the same aim in mind, other cosmetic companies strategically place consultants (you can easily spot them by their white coats, perfect faces and expensive aromas) in department stores.

Market segments based on delivery also may rely on additional criteria, including the following:

- Any-time availability (corner shops)
- Anywhere availability (petrol stations)
- Guaranteed availability (video rental outlets)
- Time sensitivity (flowers, pizza, produce)

Wondering why they buy

When it comes down to really satisfying customers' needs over the long haul, you can't forget the big picture (see Chapter 5). Perhaps the most difficult – and useful – questions that you can ask yourself about customers have to do with why they buy in the first place. These questions are:

- What are customers looking for?
- What's important to them?
- What motivates them?
- How do they perceive things?
- How do they make choices?

When you group customers by using the answers to these questions, you create market segments based on the benefits that customers are looking for. Because these market segments describe your customers from *their* point of view, rather than your own, they provide the best opportunity for you to satisfy the particular needs of an entire customer group.

What do they get?

As you try to figure out exactly why customers buy products and services in your marketplace, start a list of the benefits that you think they're looking for. We know what you're probably thinking – that product benefits sound an awful lot like product features. But in subtle yet crucial ways, product *benefits* and product *features* are different.

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> *Features* are defined in terms of products or services. A car, for example, may have a manual transmission (as opposed to automatic) and may come with accessories such as electric windows, air conditioning and a CD player. *Benefits,* on the other hand, are defined by the customer. Depending on the customer, the benefits of a manual transmission may be in handling and responsiveness, or in improved fuel consumption. Accessories may represent luxury or may simply be elements of convenience. Again, the benefits are in the eyes of the customer.

You absolutely must understand the difference between benefits and features if you're going to use the market segments that you come up with to create an effective business plan. Take a moment to think about the business situations sketched out in Figure 6-3.

Which of the benefits listed in Figure 6-3 represent genuine benefits to the customers of each company? This question is a trick one, of course. *You* don't define benefits – the *customers* do. You can easily imagine that certain groups of customers in each market seek any and all these potential benefits.

Figure 6-3: Consider these business situations.

Choose The Customer Benefits

Situation	*Potential customer benefits*
A boutique offers upmarket bath and beauty products imported from France, tasteful gift wrapping, and hassle-free delivery anywhere in the world.	❑ A nice place to go after lunch when there's extra time to kill ❑ The opportunity to impress relatives back in Sweden ❑ An alternative to divorce after discovering that today's the anniversary ❑ Aromatherapy after an ugly day at the office
A franchised quick-printing outlet provides self-service copy machines; sells custom-made stationery and business cards; and offers two-hour rush jobs on flyers, posters, and newsletters.	❑ The ability to look like a big company — at least on paper ❑ A money-saving alternative to buying a copier ❑ A threat used to keep the printing and graphics supplier in line ❑ A job-saver when the printed brochures don't arrive at the trade show
A semiconductor manufacturer sells customised chips to high-tech companies for use in brand-name consumer products, including home-electronics gadgets, computers, and games.	❑ An extension of the in-house research and development department ❑ An easy way to expand the product line ❑ A weapon in the cost/price wars ❑ A way to reduce a new product's time to market

AHEAD OF THE PACK

To identify the benefits your products offer, choose one of your products or services and follow these steps:

1. **Draw a mental image of the product or service, based on its features, attributes and options.**
2. **Put that picture completely aside for a moment.**
3. **Place yourself in your customers' shoes.**
4. **Now create a new description of the product or service from your customers' viewpoint that focuses on the benefits that the customers are after.**

Grouping customers based on the particular benefits that they're looking for when they select a product or service in your market is the key to satisfying individual customers and keeping them happy in the long run.

How do they decide?

Customers are bound to approach your market in different ways, and you can often identify market segments based on certain customer traits as they relate to your own business. Some of the conditions that guide customer buying decisions include the following:

- **Speed of the purchase decision.** The *decision-making process* (DMP) that customers go through before they purchase a product or service varies, depending on the product or service's complexity and on its price tag. People may buy chewing gum at a corner shop without much thought. But car dealerships and estate agents face a completely different DMP in their customers, resulting in a slower decision to buy.
- **The actual decision-maker.** Families of one sort or another represent a common *decision-making unit* (DMU) that's involved in buying various consumer goods. But who in the family has the final word? If you're in the business of selling clothes designed for teenagers, for example, it makes a big difference whether the kids have the final say or whether Mum or Dad is always in the background, giving the thumbs-up or thumbs-down sign. This difference alone may lead to two separate market segments, each of which has unique requirements.

- **Customer loyalty.** The way that companies relate to their own customers can easily define a set of market segments. Supermarkets, for example, have gone out of their way to identify and encourage customers based on their loyalty. You've probably been asked to join more than one loyalty card programme offered by shops that promise to cater to and reward you for being a member of a loyal customer group.
- **Level of product use.** In many industries, a small percentage of consumers account for a large percentage of sales. If you want to sell sherry, for example, you can't ignore the heavy-sherry-drinking population. In the UK, 85 per cent of sherry sales are accounted for by the over-50s and only 1 per cent is drunk by the under-24s. Keeping this high-consumption group of customers satisfied can be profitable indeed.

There is a popular theory that business buyers are hard-nosed, cold-hearted Scrooges, making entirely rational choices with the sole goal of doing the best they can for their shareholders. If this opinion were really the case, an awful lot of promotional gift suppliers would be out of business. Pharmaceutical companies could fire their sales forces, slashing costs by billions. All doctors and pharmacists would have to do is read up the research proof on drugs and prescribe accordingly. That probably wouldn't take any more time than listening to a rep make their pitch.

At the end of the day, people buy from people and that's where Maslow's needs hierarchy swings back into play. 'No one ever got fired buying IBM' was a much quoted phrase in buying departments in the days when IBM's main business was selling computers. This phrase simply meant that the buyer could feel secure making that decision as IBM's reputation was high. Buying anywhere else, even if the specification was better and the price lower was personally risky. IBM's sales force could use the buyer's need to feel safe to great advantage in their presentations.

You can group customers in many ways as you go about the creative process of dividing markets up into segments:

- To understand *who* customers are, look at where they live, what they do and how they play.
- To understand *what* customers are buying, look at the features, packaging and pricing of the products, and consider where the customers shop.
- To understand *why* customers buy, look at the benefits that they're after and the ways in which they make up their minds.

Finding Useful Market Segments

Simply coming up with a clever way to describe a group of customers isn't good enough, of course. A market segment is useful only if it allows you to deliver something of value to those customers – and to do so profitably. The fact is that not all the market segments that you come up with are going to pan out. What should you look for if you want to find a really useful market segment? In general, you want to make sure that it has the following characteristics:

- A size that you can manage.

- Customers you can identify.
- Customers you can reach.

Is the segment the right size?

Identifying useful market segments requires a delicate balance between defining your markets so broadly that they don't offer you any guidance in planning and defining them so narrowly that they're ultimately impractical and unprofitable. A useful market segment has to be manageable. The right size depends on your particular business situation, including your resources, the competition and your customers' requirements.

Choosing a manageable group of customers takes you back to the twin business goals of efficiency and effectiveness (covered more extensively in Chapter 2). You want to be effective in serving your market segment, but you also have to be efficient. For British Telecom, Ford, or Unilever, manageable market segments are likely to be rather large and quite different from those of a boutique, a high-tech startup firm, or a small, ecologically conscious manufacturing company.

A rather obvious trend over the past half-century has been to slice markets into smaller and smaller pieces. Headlines in the business press tell the story:

- 'Mass markets are all the rage' (1950s).
- 'Market segments come of age' (1960s).
- 'Niche markets have arrived' (1970s).
- 'Mass customisation is in' (1980s).
- 'Micromarkets are hot' (1990s).
- 'E-Markets make the running' (2000s).

Clearly, the notion of what a manageable market segment is has changed over the years. Market segments are shrinking. Why? Customers continue to get more sophisticated and demanding in all markets, and companies have found new ways to become more efficient and effective at what they do. How have they done it? In a word: computers.

Did you know, for example, that your credit card company makes a great deal of money by selling information about you to other companies? Each time you make a purchase with your card, you reveal something highly personal and unique about yourself. Sophisticated software programs analyse your revelations (and those of your friends, neighbours and fellow consumers), using a variety of high-tech tools to place you in a particular consumer category. Companies – and maybe yours is one of them – pay handsomely for your name, address and type so that they can target you directly with products and services that are tailored precisely to your identified needs.

You can bet that your own customers, whoever they are, will become more demanding over time and that your competitors are bound to become more adept at serving smaller markets. As you choose the manageable market segments in which you want to compete, make sure that you factor in ways to use information technology in your own business.

Can customers be identified?

As you piece together a complete picture of your customers, you want to take advantage of all the different ways that we've introduced to describe them. In particular, market segments based on why customers buy are often the best, because they define groups of customers who have similar needs. Whenever possible, you want to come up with market segments that take into account your customers' viewpoints – the benefits that they're looking for, as well as their buying behaviour.

But then what? Unfortunately, sometimes it can be really hard to detect intimate customer behaviour – motives, wants, needs, preferences – from the outside (unless you're a psychotherapist, of course, or are friends with a behavioural scientist). You may know what these people are really like, but how do you go about tracking them down? If you want to be able to recognise the customers in your market segment, you're going to have to tie their behaviour to characteristics that you can see.

> Suppose that you discover a particular employee type based on an attitude about work. Members of this group would like to be more productive on the job, yet they feel neglected and frustrated with their working conditions and office environment. Perhaps you've identified a potential market segment. But what next? How do you recognise these potential customers? Well, maybe you go on to discover that many of these workers are left-handed and would feel more comfortable with their numeric keypads on the left side of the computer keyboard and with their handsets on the right side of the telephone. Now you've taken a major step toward defining a useful market segment, because the segment is based on customer wants and needs, and is made up of customers who can be described, observed and identified.

Given this situation, you may have the urge to take a planning shortcut and base your market segment entirely on what you observe: left-handers, who, after all, constitute about 10 per cent of the population. Bingo! You decide to design and produce office equipment exclusively for left-handed customers. But wait, control that urge. Before you identify a really useful market segment, you need to look at one more requirement that needs to be satisfied.

Can the market be reached?

After you define a promising market segment that's based on need and whose customers you can describe, you have to develop ways of communicating with those customers – ways that are both efficient and effective. It's not enough just to know that this group of customers exists somewhere out there in the consumer universe, even if you can describe and recognise them. You have to be able to set up an affordable way to be in contact with them through advertising, promotions and the delivery of your product or service.

In the case of the left-handers market, for example, you have to devise a plan for marketing and distribution that ties into the common behaviour of this group. Ideally, you'd like to get the full attention of left-handers without incurring the costs of reaching the 90 per cent of people in the right-handed world as well. But just how do you gain the attention of, and access to, left-handed customers? An easy method would be to place ads in *Southpaw Press* or *The Gauche Gazette* and to make your products available at all Lefties Outlet shops. The catch is that none of these companies exist.

Maybe you shouldn’t give up just yet. But if you can’t come up with creative ways to reach out to, and communicate with, left-handed customers, they’re really not a useful market segment after all. In addition to having similar needs, common observable traits and a manageable size, a useful market segment has to present realistic opportunities to get to your customers. Perhaps that’s why left-handers are always so frustrated.

A few last points about market segments:

- Useful market segments have to be the right size. If they’re too big, they’re not effective. If they’re too small, they’re not efficient.
- To use a market segment, you need a practical way to identify the customers in the group.
- To be really useful, a market segment must be a group of customers you can actually reach.

Chapter 7

Scoping Out Your Competition

In This Chapter

- Understanding the value of competition
- Identifying your real competitors
- Making use of strategic groups
- Tracking competitors' actions
- Predicting competitors' moves
- Organising competitive data

Spending time with the competition isn't anyone's idea of fun. Think that they're out to get you? You bet they are. But the more you discover about the competition, the better off you are when it comes to figuring out what they're up to. The competitor that you're familiar with is much less dangerous than an unknown enemy out there.

If you've neglected to think much about the competition so far, you're in good company; many businesses fail to take this part of planning seriously. Here are the typical excuses:

> *There's no way to know who all of our competitors really are or what they're up to anyway.*

or

> *We already know everything that there is to know about them. We compete with them every day.*

Business owners or managers in the first group wring their hands because trying to find out about the competition is tough. Those in the second group cover their eyes, assuming that if they don't look too hard, nothing bad is going to happen. Both groups are making a big mistake.

> When the Japanese decided to become global players in the car industry in the late 1960s, they planned carefully. They knew what they had to do, because they'd been taught by American business experts. First, they had to understand the consumer markets in the United States and Europe; second, they had to know everything about the worldwide competition.

So Japanese car makers went to the USA and Europe to analyse and acquire knowledge from their competitors-to-be. They visited Fiat, Volvo, General Motors, Ford, Chrysler and American Motors. They asked questions, taped meetings, took pictures, measured, sketched and studied. Through it all, they were amazed by American and European hospitality. When they got back home, of course, their plans were hatched. And the European and US car companies never knew what hit them, even though the blow was a decade or more in coming. By 2009, the entire UK independent motor industry had been eliminated. American Motors was no more, Chrysler had changed ownership more than once and the prospects of the once mighty General Motors sinking without trace were being openly debated. Only Ford, the world's biggest family dominated business felt strong enough to stand aside from a government financial bail out.

In this chapter, we show you why you need to have competitors in the first place. Then we help you identify your current competitors and your potential competitors. We look at competition from the viewpoint of customers and choices made in the marketplace. And we explore your competitors in relation to their own strategies and company structure, introducing the idea of strategic groups. After identifying your competitors, we help you understand them better by looking at what they're doing and where they're going by checking out their capabilities, strategies, goals and assumptions.

Understanding the Value of Competitors

Your competitors are almost always portrayed as being the bad guys. At best, they're nuisances. At worst, they steal customers away and take money from the till. In short, they make your business life miserable. Is this picture unfair? You bet.

Look up from the fray, and we'll point out another side to your competitors: They're the ones who invent new technologies, expand market opportunities and sometimes create entire industries . . . and believe it or not, they also bring out the best in you. Competitors force you to sharpen your strategies, hone your business plans and go that extra mile when it comes to satisfying customers.

The power of competition as a force for good has persuaded regulators around the world to loosen their grip on one major industry after another, including these:

- Airlines
- Banking
- Railways
- Telecommunications

- Utilities

In each of these industries, a newly competitive marketplace has resulted in more products, more services, more customers – and more choices for those customers. Well-run companies have grown stronger, and market expansion has made room for many new players. The biggest beneficiaries of all are those of us who travel, use cash machines, phone home and turn on the lights at night.

Competition is a force to be reckoned with because of the power of customers. (If you need a refresher on customers' needs, benefits and buying behaviour, turn to Chapters 5 and 6.) Customers are out there making market choices, deciding what to buy and where to spend money based on their needs and willingness to pay. How do they do it? The process that they go through is based on a *value equation,* which looks like this:

Customer value = Benefits ÷ Price

Figure 7-1 illustrates this equation.

The equation looks complicated, but today's consumers are good at making choices. Think about the last time you went shopping. Chances are that you stopped by the supermarket, where you used the value equation to make all sorts of trade-offs. Maybe you chose a cut of meat, weighing what you were in the mood for and what looked fresh against the price per pound. Maybe you decided that you didn't have time to drive to the discount shop, so you bought cereal in the more expensive 16-ounce box. On your way out, you picked up organic tomatoes for the salad at three times the conventional price. Driving home, you put petrol in the car, opting for the most convenient but more expensive petrol station, which added several pounds to the bill.

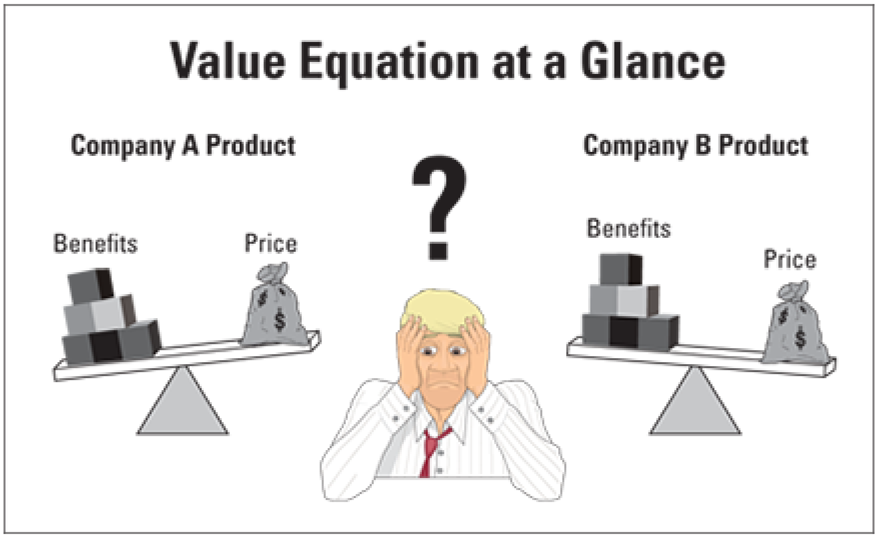

Figure 7-1: Customers make choices in the marketplace by using the value equation to weigh the value of competing products.

Competition encourages each player in your industry to figure out how to provide customers with the best value possible. Competition creates a win–win situation, so don't try to avoid it simply by ignoring your competitors. Don't ever think that you're immune to it, either. Instead, take advantage of competition and what it can do for your company. Find out how to thrive on competition.

REMEMBER

Don't forget these important points:

- Competition isn't all bad. New competitors mean more products, services and customers in your market.
- Customers weigh the benefits of a product or service against the price to measure value.
- Competition creates a win–win situation.

Identifying Your Real Competitors

Two men are backpacking in Africa. All of a sudden, they come across a lion. One of the men immediately sits down and tightens his shoelaces. The other chap looks down at him and says, 'There's no way we can outrun that lion.' The first man replies, 'I'm not interested in outrunning the lion. I just want to outrun you!' The point is that it's in your best interest to know who you're really competing against.

You can come up with lists of possible competitors based on any number of factors. The problem becomes one of sorting out which method is most successful in identifying competitors that have an impact on your company.

To understand your competition, you need to know the following things:

- How customers make choices.
- How customers use products.
- The capabilities of your competitors.
- Your competitors' strategies.
- Where future competition will come from.

Competition based on customer choice

Customers choose to buy certain products based on some sort of value equation, weighing the benefits of several products against their relative prices. But which products do customers actually compare? If you want to know who your real competitors are, you need to know how many products – and which products – your customers typically look at before they decide to buy.

Is Coke it?

The Coca-Cola Company produces almost half the soft drinks consumed in the world today, but it still has competition. It's probably safe to say, for example, that most Coke drinkers have tried a Pepsi at least once. PepsiCo accounts for about a quarter of the world soft-drink market. But what other beverages compete with Coke? The following list of competitors starts with the most obvious:

- Other colas
- Other soft drinks
- Juices and juice drinks
- Flavoured iced teas
- Iced coffees
- Mineral waters
- Beer and wine
- Tap water

Does Coke really compete with tap water? Probably. And it may even compete with bottled water, which was the reasoning behind the launch of Desani. But Coca-Cola has to draw the line somewhere when it comes to identifying its major competitors – the ones that are going to have a real impact on its business over time. Knowing where and how that line should be drawn largely depends on understanding what customers are looking for. For Coca-Cola, that understanding involves customer choices based on the following factors:

- Cola versus non-cola
- Coca-Cola versus supermarket-cola
- Diet versus non-diet
- High-calorie versus low-calorie
- Caffeinated versus caffeine-free
- Alcoholic versus non-alcoholic

The importance of these criteria differs in different markets and may change over time. Accordingly, Coca-Cola has to continually assess and reassess its competition.

If you know who your customers are and what their *selection criteria* are – that is, what they're looking for in a product or service – you can divide a list of competitors into groups based on how intensely they compete with you:

- **Head-to-head competitors:** Together, these companies represent your most intense competition. Their products always seem to be on customers' shortlists, and customers may ask you to compare your features, benefits and pricing with theirs. You want to know as much as you can about these competitors.
- **First-tier competitors:** These companies are direct competitors, but perhaps not quite as fierce as the head-to-head kind. You may run up against one of these

companies only in certain areas and among particular kinds of customers. You don't want to ignore this group too long, however, because any of these companies may have the desire and capability to come after you and become a head-to-head competitor.

- **Indirect competitors:** These competitors are the ones that you don't often think about. Their products surface as alternatives to your own only occasionally, and you usually have more important competition to worry about. Again, this group deserves a periodic review, because indirect competitors always have the potential to surprise you with competing products out of the blue.

You should be able to count your head-to-head competitors on one hand. You may have twice as many first-tier competitors to track and an equal number of indirect competitors. Be careful to keep the number of competitors that you're tracking manageable. Your head-to-head competition deserves much more attention than your indirect competitors, obviously, but you may want to set up a schedule for reviewing companies in each of the three competitor groups. Start with a weekly analysis of your head-to-head competition, a monthly review of first-tier competitors, and a quarterly review of your indirect competitors, adjusting the schedule to fit the pace of change in your industry.

One way to come up with levels of competition in your own business is to ask potential customers to consider playing their product-selection process backward for you, as described below. Sometimes, you can also get this kind of information through your salespeople or customer service representatives (if you have any). Ask potential customers for:

- The shortlist of products that they are seriously evaluating.

  These products probably are offered by your head-to-head competitors.

- The larger list that they came up with when they started investigating what was available in the market.

  These products are likely to be offered by your first-tier competitors.

- The names of products that popped into their heads when they first decided to go shopping.

  These products may include those offered by your indirect competitors.

Competition based on product use

Looking at products and services in the context of how they're going to be used by customers gives you another viewpoint from which to eye the competition. In this case, you've different steps to take:

1. **Ask customers to think about situations, applications, or occasions in which they would be likely to use your product.**
2. **Ask customers to come up with other kinds of products or services that would also be appropriate and may be just as satisfying in the same situations.**

Coca-Cola drinkers, for example, may associate outdoor sports (such as tennis and football) with enjoying a Coke. They also may single out other fizzy drinks and maybe mineral water as other possibilities to help them cool off and relax after a game. In this context, Coke has a well-defined set of competitors that may be quite different from its competition in other settings.

By viewing your competitors from a marketplace perspective – how customers choose and then use alternative products – you're rewarded with a fairly complete picture of the competitive landscape that you're facing.

Competition based on strategy

Sometimes, if you step back and look at the competitors around you, you're amazed by how different they can be. In certain industries, for example, companies that have a full product line compete with companies that offer a single product. In other industries, companies that are known for their innovative research and development compete with companies that don't develop anything on their own.

But how can this situation be? How can competitors in the same industry be so different? Over time, doesn't every company figure out the best strategies, as well as the most efficient and effective ways to do business? Shouldn't all companies end up looking pretty much alike? These are good questions. Here are two answers:

- You can't always find a 'best' way to do things. Markets and industries are complex, and different ways of doing business can exist side by side and be equally successful.

- A company that does business one way doesn't always find it easy to change and start doing business another way.

Identifying competitors based on their unique capabilities and strategies has a great deal in common with some of the industry analysis discussed in Chapter 4. Sometimes, you can take that analysis one step further and divide companies in your industry into groups based on what they do and how they operate – sort of like the market segments that we talk about in Chapter 6, but this time applied to companies rather than individual customers.

A *strategic group* is a set of companies in a particular industry that look a lot alike and tend to behave in similar ways. In particular, firms in the same strategic group have the following traits:

- They display similar characteristics (size, geography, rate of growth).
- They operate in similar ways (degree of risk-taking, level of aggressiveness).
- They demonstrate similar capabilities (people, skills, image, money in the bank).
- They pursue related strategies (distribution, marketing and product-line decisions).

You can apply all sorts of business criteria to identify the most useful strategic groups. Although every industry is different, you need to consider these general variables:

- Companies that manufacture most of their product components versus those that assemble or resell products.
- Companies that produce name-brand products versus those that produce generic or private-label brands.
- Companies that rely on their own R&D (research and development) versus those that license or buy technology.
- Companies that have a full product line versus those that have limited or specialised products.
- Companies that emphasise marketing versus those that focus on production.
- Companies that are diversified versus those that are in only one industry.

Strategic groups fall somewhere between an individual company and the entire industry. Lumping your competition into groups is helpful, because all the companies in a strategic group tend to be affected by, and react to, changes in the marketplace in the same ways. But grouping works only if those companies stay put in their assigned group long enough to be analysed. Fortunately, they usually do.

JARGON ALERT

As part of your own industry analysis, you may have already discovered a few *entry barriers* – things that make it tough to get into your business, such as high capital costs, expensive distribution systems, new technology and regulation. You also may have come up with some *exit barriers* – things that keep competitors from getting out of the business, such as expensive factories, specialised equipment and long-term agreements. Strategic groups can have the same kind of *mobility barriers,* which tend to keep competitors where they are, in one group or another.

Strategic groups can be a great time-saver in business planning, because when you put all your competitors in one, you know where to focus your energies. You can spend most of your time analysing the companies in your own strategic group and deal with the rest of the companies in clusters, rather than track each of them separately.

EXAMPLE

A strategic circle of friends

The worldwide motor industry is so large and complex that keeping track of competitors would be tough without the help of strategic groups. Fortunately, car makers can use several criteria to break the automotive world into more manageable industry segments.

When Ford looks out over the competitive landscape, the competitors that loom the largest are likely to be Toyota, Nissan, Fiat and Volkswagen. What do these companies have in common that places them in the same strategic group? Well, for starters, all of them have these traits:

- They are extremely large companies.
- They are involved in almost all aspects of the car-making process.
- They have a full line of cars with many sizes, models and prices.
- They distribute vehicles on a global scale.

These companies don't have much choice but to know as much as there is to know about one another in terms of resources, capabilities, goals and strategies. Although Ford is going to keep its eye on BMW, Volvo and Mercedes-Benz, the company isn't going to put as much effort into tracking those luxury car makers as it does into tracking Volkswagen and

Toyota. By identifying the members of its own strategic group, Ford focuses on the competitors that are likely to have the greatest impact on its business.

To divide your own list of competitors into strategic groups, follow these steps:

1. **Put your competitors in a small number of groups, based on how similar you think that they are to one another.**
2. **Add your own company to one of the groups.**
3. **Looking at each group carefully, try to come up with the basic criteria that you used to make your selections.**
4. **Take a hard look at the group in which you put your own company.**

   Are these competitors really closest to you in terms of their characteristics and the criteria that you've identified?
5. **Adjust the groups, if necessary, and work on additional criteria that may point to other strategic groupings.**

WARNING!

Strategic groups are relevant and useful in many industries; they often provide a means of organising competitors in ways that can simplify the competitive landscape. But keep in mind that all industries don't play by the same rules. If the mobility barriers aren't high, for example, companies are free to adjust their capabilities and change strategies quickly, limiting the usefulness of long-term strategic groups. Make sure that the groups you identify in your own industry are real and won't dissolve before you've had a chance to analyse them.

Competition in the future

Always remember that competitors can come out of nowhere. Keep at least one eye on your potential competitors. Who are they? The following are the most likely sources of new competition:

- **Market expansion:** A company that's operated successfully for years outside your geographic region decides to expand into your territory, becoming an overnight competitor. Alternatively, a company that has a product that dominates another market segment sees an opportunity to target your customers as well.
- **Product expansion:** A company decides to take advantage of its brand name, its technology, or its distribution system and creates a new product line in direct competition with your own.
- **Backward integration:** One of your major customers decides that it can do what you do – and do it better and cheaper. So the former customer sets up shop and hands the business that it used to give to you to its in-house group. All of a sudden, your old customer is a new competitor.
- **Forward integration:** Your company buys many things from many suppliers. One day, one of those suppliers decides that it can bring all the pieces together as well as you can. So it creates a new business and a product line that suddenly competes with yours.
- **Change in fortune:** Out of the blue, a minor competitor is suddenly purchased by a major company. With access to new resources (financing, marketing and distribution), the minor competitor becomes a major player. You really have to watch out for these competitors; when they do come out of nowhere, they

are likely to catch you off guard and be all the more dangerous.

Keeping track of your future competitors is as important as tracking your current ones. Just keep your eyes and ears open.

Sounds like we need a summary of all this:

- To find out who your competitors are, ask customers what other companies' products they consider buying.
- Examine how your products are used if you want to identify alternative products that your customers may turn to.
- Your capabilities and strategy determine who you compete with in the marketplace.
- New competitors arise whenever markets expand, new products appear, or the rules of your industry change.

Predicting Your Competitors' Moves

Trying to predict where your competitors are headed isn't easy, of course; looking into the future never is. But where your competitors plan to be in the future certainly depends on where they are today, as well as on their capabilities and the strategies that they've set in motion. Predicting your competitors' actions also requires a little insight into what they think and how they think – the goals that they aim for, as well as the assumptions that they make about the industry.

Figuring out their goals

Your competitors' mission, vision and values statements tell you a great deal about what they expect of themselves in the future. These documents aren't top secret; they're meant to communicate a company's intentions to all its stakeholders, and you should take advantage of them. You don't have to read your competitors' minds. All you have to do is read what they say about themselves and what they're going to do.

Companies often put their mission, vision and values statements on their website, usually in the 'About us' section of their websites.

When Jack Welch took over as CEO of General Electric in 1981, he rather quickly spelled out the giant company's new goals to his senior managers: market share, market share and market share. GE would become either first or second in each of its businesses – or else. No one misunderstood what the 'or else' meant. GE's competitors could (and should) have listened to Welch, because the company was sending a clear signal about how it intended to compete in the future. Any company that was going head-to-head with GE for market share was going to have a battle on its hands. The companies that understood this fact early had a warning and the opportunity to adjust their own strategies to meet a changed competitive landscape.

To discover your competitors' mission, vision and value statements, try the following steps:

1. **Select a shortlist of competitors.**
2. **Dig up as much information as you can find on each competitor's values, vision and mission statements, as well as any stated business goals and objectives.**

If the companies are public, a good place to start is with their annual reports to shareholders.

3. Write down your competitors’ financial and strategic goals.

Don’t forget to read between the lines. In particular, look for the following:

- Market-share goals
- Revenue targets
- Profitability targets
- Technology milestones
- Customer-service goals
- Distribution targets

Uncovering their assumptions

What your competitors plan to do is usually related to their assumptions about themselves and your industry – how they think and the way in which they see the world. Sometimes you can get important clues about your competitors’ assumptions by going back over their goals and objectives. Your competitors find it hard to make a statement about where they want to go without giving something away about where they think they are today. You can often come up with valuable insights by comparing your competitors’ assumptions about the industry with what you know to be true.

In the 1950s, for example, British and American businesses operated under the broad assumption that all that Japanese companies could ever produce were cheap, poorly made products that were meant to be thrown away. During that decade, products from Japan were collectively referred to as 'Japanese junk'. When British and American companies finally realised that their assumption couldn't be farther from the truth, the competitive damage had already been done. This monumental misconception altered the balance of global competition and trade for a generation. With the 1995 sale of Zenith Corporation to a Korean conglomerate, for example, the US was no longer a serious television manufacturer. Today, British and American companies often make the equally broad and misguided assumption that they will find it simply impossible to compete against aggressive Asian firms.

So assumptions aren't always true – that's why they're called assumptions in the first place. False assumptions can be dangerous for companies, especially when they lead to so-called conventional wisdom or result in competitive blind spots:

- **Conventional wisdom:** Prevailing assumptions in an industry often become so ingrained that they're mistaken for the gospel truth. Conventional wisdom is almost always proved wrong when an unconventional competitor comes along. Watch your competitors for signs that they're taking their own assumptions too seriously and are forgetting the importance of always asking 'Why?'

- **Blind spots:** You can all too easily miss the significance of events or trends in an industry, especially if they run counter to prevailing notions and conventional wisdom. A competitor's world view often dictates what that company is going to see and not see. As you track your competitors, look closely for actions and reactions that may point to blind spots and a misreading of what's happening in the marketplace.

Bear in mind that:

- Your competitors' mission, values and vision statements are a great way to discover their goals for the future.
- Competitors sometimes signal their intentions by the way they behave in the marketplace.
- Your competitors' assumptions about the industry – right or wrong – offer important clues about how they are going to act.

Competing to Win

The more you find out about competitors, the better off you are when it comes to understanding their actions and anticipating their moves.

Remember – the more you discover about your competitors, the more they're probably discovering about you. It's safe to say that your company probably is putting out as much information about itself and its intentions as your competitors are, so you must listen to yourself as to your competition. Put yourself on your own list of competitors. Interpret your own actions from a competitor's point of view. That way, you understand the implications of your own competitive behaviour in the industry as well as you understand your competitors' behaviour.

If you're serious about the competition, you can't do all of this analysis one time, wash your hands and be finished with it. You're going to have to monitor your competitors in a systematic way. If you observe them well, you're in the enviable position of choosing the competitive battles that you want to win, rather than being ambushed in competitive situations that you're bound to lose.

Organising facts and figures

To find out what really makes your competitors tick, you need to take advantage of data from all sorts of places. (Refer to Chapter 4 for a list of resources.) You can find facts and figures on the competition almost anywhere, including the following sources:

- Business, trade and technical publications
- Trade shows
- Company documents
- Company websites

- Government filings
- Stock-market analysts
- Management speeches
- Suppliers and distributors
- Customer feedback
- Your own employees

MANAGER'S TIP

The last item in the list deserves a special note. Your own employees are an invaluable source of data when it comes to the competition. As you look inside your company, start with your salespeople, who are slap-bang in the middle of the information stream, talking with customers, dealing with distributors and occasionally running into competitors. They're privy to all the gossip, rumours and news flashes that flow through your industry. Take advantage of their position, and figure out how to capture what they know.

You have to be a little careful about gathering information from employees other than your salespeople. In many industries, people move from job to job and company to company. There's nothing wrong with brainstorming about what a competitor may be up to, but warning flags should go up if someone pulls out documents marked 'Top Secret'. It's not only wrong, but illegal for you to use certain kinds of knowledge that a former employee may have about a competitor – anything that may be construed as proprietary information or trade secrets. There was plenty of bitterness between General Motors and Volkswagen over a vice president who changed sides, not to mention the lawsuits and criminal charges. If you feel that you're on shaky ground, check out Chapter 2 and your company's values statement, and talk to your company's lawyer.

You need a way to organise the facts and figures that you collect from many sources to turn them into competitive information that you can really use. Filing cabinets and file folders do the trick, but you may want to think about setting up a computer system to keep track of the data. As you set up the system, keep in mind that information about your competitors will not fall in your lap in the next two days – instead, it will trickle in over weeks, months and years.

More than likely, you already have bits and pieces of data on your key competitors stashed away. You just need to develop a procedure that keeps the bits and pieces coming in and then brings them together to create a useful, up-to-date profile of the competition. The following steps should help you develop that procedure:

1. **Start with a pilot procedure for tracking competitors.**

   Beginning with your sales force (or yourself, if you're self-employed), set up a trial system to capture competitive data from the sales channel. Create periodic paper reports in a standard format, or computerise the process, if you can.

2. **Set up a company-wide system for tracking competitors.**

   Formalise the process of identifying and tracking competitors throughout the company, so that you've accurate information on the competition when and where you need it. Competitor analysis is too important to do haphazardly or only when a crisis hits.

3. **Make someone responsible for competitor analysis**.

   Put a manager (or yourself) in charge of competitor analysis for your company. That way, everyone understands that competitive analysis is important. Your employees also have someone to turn to when they need to give or get information on the competition.

4. **Make it your priority to see that the system is carried out.**

   Make sure that competitor analysis is taken seriously in your company by including it in your own business plan. Then become an advocate, insisting that the competition be addressed in any planning document that comes across your desk.

Choosing your battles

The more thoroughly you understand your competitors – what they've done in the past, what they're doing now and what they're likely to do in the future – the better you can plan for and choose the competitive battles that you want to be part of.

Naturally, you want to go after markets where you've a strategy and the capability to succeed. But you're never alone in any marketplace for long. By embracing the competition rather than ignoring it, you've the added advantage of knowing where the competition is weakest. Choose your battleground by combining your strengths with their weaknesses. That way, you win half the battle before the contest begins.

Remember the following when figuring out the competition:

- Tracking and understanding your competition is an ongoing process.
- To keep up to date, create a system for gathering and organising information on your competitors.
- The better you know your competitors, the better you can choose battles that you can win.

Part III

Weighing Up Your Company's Prospects

'Still no luck with the bank loan, Mr. Blenkinsop?'

In this part . . .

Whenever you tackle something new, whether it's going back to school, buying a house, changing jobs, starting a business, or planning for change – nagging questions come up. Is the new strategy really the right decision? Are you up to the challenge? Will things work out in the end? They're good questions, because they force you to be honest about the capabilities and qualities that you bring to the table.

In this part, we help you look in the mirror and make an honest assessment about what you see. We set out to discover all the capabilities and resources that you have. We try to determine which of them are strengths and which are weaknesses by looking at what you need to succeed in your sector and industry – and what opportunities and threats you face. We help you focus on what your organisation does best by looking at the areas where you provide the most value to customers, and then we help you figure out how you can maintain and extend the competitive advantages you already have in the market. Finally, we turn to your finances and help you create an objective portrait of your business based on your income, profits, assets, and cash position, and then we help you use them to create a forecast and a budget.

Chapter 8

Establishing Your Starting Position

In This Chapter

- Discovering your capabilities and resources
- Reviewing critical success factors
- Identifying company strengths and weaknesses
- Recognising opportunities and threats
- Analysing your situation by using a SWOT grid

When you look into a mirror, you expect to see an image of yourself. When you listen to your voice on an answering machine, you expect to hear yourself. When you look at photos or home videos, you expect to recognise yourself. But how many times have you said:

That doesn't look like me.

or:

Is that what I really sound like?

An honest self-portrait – whether seeing and hearing yourself clearly or making objective statements about your own strengths and weaknesses – is tough to put together. Strengths and weaknesses have to be measured relative to the situations at hand, and a strength in one circumstance may prove to be a weakness in another. Leadership and snap decision making, for example, may serve you extremely well in an emergency. But the same temperament may be a liability when you're part of a team that's involved in delicate give-and-take negotiations.

You're going to face similar problems in seeing clearly and objectively when you take on the task of measuring your company's internal strengths and weaknesses. You may be surprised by how many businesses fail miserably at the job of objective self-analysis – companies that cling to a distorted image of the resources that they command and the capabilities that they bring to the marketplace.

In this chapter, we help you get a handle on your company's strengths and weaknesses in relation to the opportunities and threats that you face. First, we look at ways that you can spot potential strengths and weaknesses by making a list of your capabilities and resources. Next, we show you how the critical success factors (CSFs) in your industry come into play to determine which of those capabilities and resources are strengths and which aren't. Then we help you pull all the pieces of the puzzle together – your company's strengths, weaknesses, opportunities and threats – to create a complete picture. We also create a strategic balance sheet that helps you keep track of where you stand, what you should do and when you should do it.

Sizing Up Situation Analysis

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We examine your company's situation by using a tried-and-tested approach known as SWOT. Don't worry about guns or sharpshooters; *SWOT* is an acronym for *strengths, weaknesses, opportunities* and *threats*.

Your company's strengths and weaknesses can't be measured in a vacuum, of course. Your situation depends not only on your own capabilities and resources, but also on the opportunities and threats that arise from things beyond your control. Check out Chapter 4 to review opportunities and threats. Depending on the situations that you face, opportunities and threats appear, disappear and change all the time, and your company's strengths and weaknesses change with them.

A thorough SWOT analysis is something that you complete more than once. In fact, you probably should carry out a SWOT review on a regular basis, depending on how fast your business environment, the industry and your own company change.

Identifying Strengths and Weaknesses

Your company's *strengths* are the capabilities, resources and skills that you can draw upon to carry out strategies, implement plans and achieve the goals that you've set for yourself. Your company's *weaknesses* are any lack of skills or a deficiency in your capabilities and resources relative to the competition that may stop you from acting on strategies and plans or accomplishing your goals.

To capture your own first impressions of your company, complete the Company Strengths and Weaknesses Questionnaire (see Figure 8-1). On the right side of the questionnaire, assess your capabilities and resources in each area. On the left side, rate the importance of these elements to your industry.

When a strength becomes a weakness

For 30 years, Marks and Spencer hired its managers and supervisors from a talent pool that consisted almost exclusively of young men and women under 26 years of age who had graduated from its own Management Training Programme. M&S saw this hiring policy as being a major corporate strength, creating a remarkable sense of unity and consistency in its outlook and its internal culture. The company didn't need seminars and workshops to develop a common sense of values and vision; M&S values were built in from the beginning.

But that apparent strength was challenged in the late 1980s, when M&S's dominance and the stability of the entire retail sector were thrown up for grabs. Big food companies – Tesco, Sainsbury's and the others – encroached on M&S's traditional advantage in the quality pre-prepared market sector, and no one at M&S seemed to have the slightest idea what that was going to mean. Many forward-thinking, out-of-the-mould managers had already been driven out of the strait-jacket management line-up. Everyone in the organisation came from the same background and thought in much the same way. Nobody understood the speed or magnitude of the competitive threat – or the changes that were about to engulf the company.

What started as an important company strength turned into a serious weakness as Marks and Spencer faced a battle for survival. The company began an aggressive campaign to hire managers with different backgrounds and diverse experience. It also moved to recruit its very top management from outside of the founding family members and time-serving employees in an all-out effort to prepare for a future in which fast-moving change and fierce competition became the name of the game. M&S won a second chance in the battle for competitive advantage – many, including Woolworths, at one time the world's largest department store, haven't been so fortunate.

Finding your frames of reference

When you complete the questionnaire shown in Figure 8-1, you should have an initial list of your company's strengths and weaknesses. In order to be objective, however, you need to go beyond first impressions and look at your business assets from more than one point of view. Different frames of reference offer the advantage of smoothing out biases that are bound to creep into a single viewpoint. They also offer the best chance of making your list as complete as it can be. Consider the following viewpoints:

- **Internal view.** Draw on the management experience inside your company (use your own experience, or that of your friends and former co-workers if you're self-employed) to come up with a consensus on your business strengths and weaknesses. You may want to use the same people to get a sense of what's happened in the recent past as well. A little corporate history can show you how your company's strengths and weaknesses have changed over time – and how easily the organisation shifts gears.
- **External view.** Beware of becoming too self-absorbed in this analysis. Make sure that you step back and look around, using your competitors as yardsticks, if you can. All of your competitors do business in the same industry and marketplace that you do, and they're strong or weak in all the key areas that you're interested in. If your list is going to mean anything when the time comes to apply it to your own business situation, your strengths and weaknesses have to be measured against those of your competitors. (Flip to Chapter 7 for more information on the competition.)

- **Outside view.** Perhaps you identify company strengths that are assets only because your competitors haven't reacted yet, or maybe you ignore real weaknesses because everybody else has them, too. Every once in a while, you need an objective outside assessment of what's happening in your business. That's where consultants can actually be of some use. If you can't afford that kind of advice, make sure that you at least monitor the business press to get an outside view of what the experts are saying about your industry's key players. Business Link in England (and equivalents in Scotland and Wales) can generally help firms to set up an objective appraisal of the strengths and weaknesses of a business.

Figure 8-1: Company Strengths and Weaknesses Questionnaire
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Company Strengths and Weaknesses Questionnaire

Importance to Industry			*Business Area*	*Your Capabilities and Resources*			
Low	*Moderate*	*High*		*Poor*	*Fair*	*Good*	*Excellent*
❑	❑	❑	Management	❑	❑	❑	❑
❑	❑	❑	Organisation	❑	❑	❑	❑
❑	❑	❑	Customer base	❑	❑	❑	❑
❑	❑	❑	Research & development	❑	❑	❑	❑
❑	❑	❑	Operations	❑	❑	❑	❑
❑	❑	❑	Marketing & sales	❑	❑	❑	❑
❑	❑	❑	Distribution & delivery	❑	❑	❑	❑
❑	❑	❑	Financial condition	❑	❑	❑	❑

If you don't have a management team that can conduct a situation analysis, bring together one of the informal groups that you rely on for some of your other planning tasks. Ask the group members to spend a little time analysing strengths and weaknesses. Make sure that the group looks at your company's situation from various perspectives, using the different frames of reference in the preceding list.

Counting up your capabilities and resources

In putting together a list of your company's capabilities and resources, cast your net as widely as possible. Look at your capabilities and resources in a systematic way, reviewing all the business areas introduced in the Company Strengths and Weaknesses Questionnaire (refer to Figure 8-1 earlier in this chapter). In each area, try to identify as many capabilities and resources as possible by using different frames of reference. At the same time, assess how relevant each capability or resource is in helping you to carry out your plans and to achieve your business goals. You're going to use this master list as raw material when the time comes to identify your company's strengths and weaknesses.

Management: Setting direction from the top

Your company's management team brings together skills, talent and commitment. You want team members to find their direction from your company's mission, vision and values statements, as well as from the business goals and objectives that you plan to achieve. Top-notch managers and owners are particularly important in industries that face increasing competition or fast-changing technologies. It's hard to think of an industry that doesn't fit into one of these two categories.

Management is there to determine what your company's going to do. Senior managers are officially charged with setting the direction and strategy for your company, but all managers indirectly set a tone that encourages certain activities and discourages others. Office products leader 3M, for example, gives its managers the freedom to be entrepreneurs in their own right, allowing the company to recognise and invest in new business opportunities with the speed and flexibility of much smaller rivals. The Body Shop, on the other hand, is recognised for its environmentallly aware management. The company attracts highly qualified men and women who want to work in a business environment that values both personal and corporate social responsibility.

Following are a few key questions to ask about the management and/or ownership of your company:

- How long have managers been around at various levels in your company? (Alternatively, what variety of experiences do you have as an owner?)
- Does your company plan to hire from the outside or promote from within?
- What's the general tone set by you or your company's management?
- Do you have a management development programme in place? (Alternatively, how do you plan to develop your own skills, if you're a sole proprietor?)

- What backgrounds do you or your managers have?
- How is management performance measured in your company?
- How would you rate the general quality of your own skills or those of your management team?

Organisation: Bringing people together

The people who make up your company and its work force represent a key resource, both in terms of who they are and how they're organised. Although human resources are important to all companies, they're especially critical to companies in service industries, in which people are a big part of the product. (We take a closer look at your organisation in Chapter 16 when we talk about making your business plan work.)

Your organisation starts with who your employees are, and that depends first on how well you select and train them. Beyond that, the work environment and your company's incentive systems determine who goes on to become a dedicated, hard-working employee and who gets frustrated and finally gives up. The setup of your organisation (how it's structured and how it adapts) can be just as important as your employees are when it comes to creating a company team – even a small one – that performs at the highest levels, year in and year out.

Pharmaceutical companies, for example, hire hundreds of new sales people annually. Are these companies really growing that fast? Of course not. But the industry routinely loses up to 60 per cent of new employees by the end of the third year, after investing heavily in their training. Why? The industry discovered that one problem was in their selection process: too many of their new sales people were unsuited to the stresses and strains of hitting challenging sales goals and making upwards of 20 field calls a day, with hundreds of miles of driving thrown in. After all, the typical new sales person was a young university graduate. So the industry revised its hiring practices – candidate advertising, interviewing and psychometric testing – and has already started to see major improvements in both sales performance and longevity.

Following are some key questions about your organisation to consider:

- What words best describe the overall structure of your organisation?
- How many reporting levels do you have between a front-line employee and your CEO?
- How often does your company reorganise?
- What are your employees' general attitudes to their jobs and responsibilities?
- How long does the average employee stay with your company?
- How does your absenteeism level compare with industry benchmarks?

- Does your company have ways to measure and track employees' attitudes and morale?
- What does your company do to maintain morale and positive job performance?

Customer base: Pleasing the crowds

Your company's business depends, to a great extent, on the satisfaction and loyalty of your customers. In Chapters 5 and 6, you discover who those customers are and how you can find out as much as you can about them, because understanding your customers and satisfying their wants and needs are critical to the future of your company.

Nordstrom, for example, is an American department-store chain that appeals to upmarket shoppers. The company bases its reputation on the simple idea that the customer is always right. And the company means it. As the story goes, a disgruntled customer once stormed into the back loading dock of a Nordstrom store, demanding satisfaction and the immediate replacement of defective tyres that he'd recently purchased. The store managers were extremely polite. They quickly discovered that the man was indeed one of their best customers, and they arranged an immediate reimbursement for the full price of the tyres. In a better mood, the customer decided that he'd rather just have a new set installed. When he asked where he should take the car, he was informed that Nordstrom doesn't sell tyres. Obviously, this man became a satisfied customer – and a Nordstrom advocate for life.

Here are a few questions to consider when you study your own customer base:

- What does your company do to create loyal customers?
- How much effort do you put into tracking customers' attitudes, satisfaction and loyalty?
- What do you offer customers that keeps them coming back?
- How easy and economical is it for your company to acquire new customers?
- How many years does a typical customer stay with you?
- How many markets does your company serve?
- Are you number one or number two in the markets in which you compete?

Research and development: Inventing the future

Research and development (R&D) often plays an important role in the long-term success of a company, and R&D is particularly critical in industries in which new and better products are coming along. But research and product development must balance the other forces that are at work in your marketplace. R&D is one business area in which even an A-1 team effort doesn't automatically pay off.

Consider the cosmetics industry. Estée Lauder or Revlon could easily spend millions of additional pounds on R&D. These companies could fund any number of studies to find out more about everything from the properties of skin to humans' sense of smell. They could construct state-of-the-art laboratories, hire teams of dedicated dermatologists and top-notch chemists, and in the process become unchallenged leaders in basic cosmetics research. But would the funds invested in these additional capabilities translate into enduring company strengths? Probably not. These companies don't want their products to be turned into drugs that have to be regulated by government departments. Most cosmetics products live or die on the strength of their images and on the resources invested in advertising and promoting them. Customers tend to buy the hype behind beauty aids – not the ingredients inside them.

On the other hand, the makers of integrated circuits and microprocessors – the brains of computers – have little choice but to commit themselves to aggressive R&D efforts. Intel and Motorola have world-class R&D organisations because their industry is driven by continuous product innovation. These companies continually push for greater processing speed and power in ever-smaller packages. Failure to maintain leadership in research can result in catastrophe for either company.

The following key questions help you examine the role of R&D in your company:

- To what extent is your industry driven by technology?

- Can you get enough results for your money to bother with R&D?
- Does your company have a consistent, long-term commitment to R&D?
- How many pounds do you spend on basic research as opposed to applied research?
- How long have the key people on your research staff been with you?
- Does your company protect what it owns with copyrights and patents?
- Have you set up partnerships with universities or outside research labs?
- Do you have technology agreements with other companies in your industry?
- Are you aware of the favourable UK tax treatment of R&D expenditure?
- Are you aware of possible UK government grant aid for R&D projects?

Operations: Making things work

The operations side of your business is obviously critical if you happen to be a manufacturing company. The products that you make (and the way that they work, how long they last and what they cost) depend entirely on the capabilities and resources of your production facilities and work force – so much so that you can easily forget that operations are equally important to companies in the service sector. Customers demand value in all markets today, and they're simply unwilling to pay for inefficiencies in any business. Whether you make cars or carpets, produce cereal boxes or serial ports, run a bank or manage a hotel, operations are at the heart of your enterprise.

Operations in your own company probably are driven, to some extent, by costs on one side and product or service quality on the other. The tension between controlling costs and improving quality has led many companies to explore ways to reduce costs and increase quality at the same time. One way for you to do that is to involve outside suppliers in certain aspects of your operations, if those suppliers have resources that you can't match. Another way to achieve both goals is to streamline parts of your operations (through automation, for example).

Automation can also be a source of growth and may even create new business opportunities for your company. The airline industry is as big as it is today because of the computer revolution; computers enable airlines to track millions of passenger reservations and itineraries at the same time. Imagine the queues at airports if airlines were still issuing tickets by hand and completing passenger flight lists by using carbon paper.

When American Airlines developed its computer-based SABRE reservation system, however, it couldn't predict that *yield management* – the capability to monitor demand for flights and continuously adjust prices to fill seats – would become as important as on-time arrivals. The company has increased its profit margins because yield-management software ensures that each American flight generates as much revenue as possible. The software is so sophisticated and successful that Robert Crandall, American Airlines' chairman, spun off SABRE as a separate company. SABRE's expertise can now be used to benefit industries such as the hotel business, in which yield-management software can automatically adjust room rates and make sure that as many beds as possible are filled each night.

Following are some questions on the operations side of your business to mull over:

- Does your company have programmes for controlling cost and improving quality?
- Has your company taken full advantage of new technologies?
- Are your production costs in line with those of the rest of the industry?
- How quickly can you boost production or expand services to meet new demand?
- Does your company use outside suppliers?
- Is your operations workforce flexible, well trained and prepared for change?
- Can you apply your operations expertise to other parts of the business?

Sales and marketing: Telling a good story

The best product or service in the world isn't going to take your company far if you don't successfully market and sell it to all those potential customers out there. Your sales and marketing people (or you, if you're operating your own small business) are your eyes and ears, giving you feedback on what customers think about and look for. Your sales and marketing people are also your voice. They tell your company's story and put your products in context, offering solutions, satisfying needs and fulfilling wants in the marketplace.

What can a marketing department possibly do, for example, to package and promote a boring old bulk chemical such as sodium bicarbonate? It turns out that such a department can do quite a bit, if connected with Arm & Hammer, which sells sodium bicarbonate (baking soda) toothpaste. The 'Wow' adverts, showing people smiling with gleaming white teeth, as if 'they had been cleaned by the dentist', ensured Arm and Hammer gained 4 per cent of the toothpaste market in Britain, just over a year after being launched. All this from a common, readily available chemical salt.

Here are a few key questions to ask about the marketing of your product line:

- How broad is your company's product or service line?
- Do consumers identify with your company's brand names?
- Do you have special processes or technologies that your competitors can't take advantage of?
- Are you investing in market research and receiving continuous customer feedback?
- Are you using all the marketing resources that are at your disposal?
- Is your company's sales force knowledgeable, energetic and persuasive?

Distribution and delivery: Completing the cycle

Distribution and delivery means that your products and services are actually getting to their final destinations and into your customers' hands. No matter how good you think your products are, your customers have to be able to get their hands on them when and where they want them. How customers shop is often just as important as what they buy, so you can't be surprised that when a different way to deliver products and services comes along (over the Internet, for example), the new system revolutionises a marketplace or even an entire economy. The Internet promises a future in which companies can reach out to their customers more directly, increasing company clout and at the same time lowering distribution costs.

Right now, your company probably distributes its products and services through *traditional channels* – time-tested ways in which you and your competitors reach customers – and your distribution and delivery costs may represent a significant part of your total expenses. The standard costs often include warehouse operations, transportation and product returns. If you're in a retail business, you can end up paying for expensive shelf space as well. Supermarkets now routinely ask for money up front before they stock a new item, and you pay more for the best locations. After all, supermarkets control what customers see – and buy – as harried shoppers troop down the aisles, children and trollies in tow.

Many innovative products and companies succeeded in the past because of their novel approaches to the costs and other hurdles associated with traditional distribution networks. When Amazon decided to enter the book market, for example, Jeff Bezos, Amazon.com's founder faced established competition and a stodgy distribution system dominated by traditional retail outlets.

Rather than tackle all these problems head-on, the company set off in a new direction. Bezos realised that no single bookstore can carry a comprehensive inventory of the books in print. The distributors who carried thousands of titles acted as the warehouse for most stores, particularly smaller booksellers. When customers asked a store for a book it did not have in stock, they filled the customer's order through one of the handful of large distributors. These companies' inventory lists were digitised in the late 1980s. The online inventory lists would enable Bezos to offer books online through the company he planned to create.

The naming of Amazon.com was based on the importance of its relative size. Bezos reasoned that the Amazon River was ten times as large as the next largest river, which was the Mississippi, in terms of volume of water and Amazon.com had six times as many titles as the world's largest physical bookstore. Amazon has revolutionised traditional bookselling and buying, and has spawned many imitators.

The following are a few questions about the distribution and delivery of your product or service:

- What are the costs associated with your company's inventory system?

- Can you reduce inventories by changing the way that orders are processed?
- How much time does it take for a customer order to get filled, and can the time be reduced?
- How many distribution channels does your company use?
- What are the relative costs in various channels, and which are most effective?
- How much control over your company do distributors have?
- Can you use any new channels to reach your customers more directly?

Financial condition: Keeping track of money

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The long-term financial health of your company determines the health of your company, full stop. You simply can't survive in business for long without having your financial house in order. Come to think of it, the things that you have to track when it comes to company finances aren't all that different from the issues that you face in running your own household. If you're just starting in business, for example, how much money your company can get its hands on up-front (your *initial capital*) is a key to survival. (Does this sound like trying to buy and furnish your first house?) When your company's up and running, you have to make sure that more money comes in than goes out (a *positive cash flow*), so that you can pay all your bills. (Remember those times when the mortgage and utility bills were due, and it wasn't payday yet?)

Figuring out how to keep your company financially fit is critical to planning your business. When you take the time to look over your important financial statements periodically, you give your company the benefit of a regular financial checkup. The checkup is usually routine, but every once in a while you uncover an early-warning symptom – profits that are too low, for example, or a promotional expense that's too large. That's when all your financial vigilance is worth it.

Here is a list of oh-so-painful questions to ask about your company's financial health (if you don't know how to answer these questions, spend time with Chapters 10 and 11):

- Are your revenue and profits growing?
- Are you carefully monitoring your company's cash flow?
- Does your company have ready access to cash reserves?
- Does your company – and every business unit or area – have a budget for the coming year?
- Do you consistently track key financial ratios for the company?
- How does your company's financial picture compare with that of the competition?

Coming up with critical success factors

You need to decide whether your capabilities and resources represent company strengths that you can leverage or weaknesses that you must correct as you plan for the future. To do that, you have to be clear about exactly what's important to your industry and the marketplace. The *critical success factors* (CSFs) are those capabilities and resources that absolutely have to be in place if you want your company to succeed over the long haul.

You may have already prepared a list of CSFs. (If you haven't, take a look at Chapter 4.) Along with a CSF list, you need a set of your company's capabilities and resources. You can use the two lists to construct a grid, which in turn allows you to compare your capabilities and resources with those that your industry thinks are important. In a perfect world, the lists would be identical, but that's seldom the case. The completed grid helps you identify your company's current strengths and weaknesses (see Figure 8-2).

To complete a grid similar to the one in Figure 8-2, remember the following:

- The capabilities and resources that you place up and down the left side of the grid are in your industry's 'must have' category. They represent CSFs.
- The capabilities and resources that you place in the top-left corner of the grid are CSFs in which your company is good or excellent. They represent your company's strengths.
- The capabilities and resources that you place in the bottom-left corner of the grid are CSFs in which your company is only fair or even poor. They represent your company's weaknesses.

Figure 8-2: Compare your capabilities and resources with those that are thought to be CSFs in your industry.

You'll find it easy to find value in the capabilities that your company already excels in, and just as easy to underestimate the importance of things that your company doesn't do as well. Try to be as objective as you can here. You may find it hard to admit that you're devoting valuable resources to things that don't really matter, and equally hard to admit that you may be neglecting key business areas.

Think about the following for your company's strengths and weaknesses:

- Different people have different ideas about what your company's strengths and weaknesses really are.
- By combining different viewpoints, both inside and outside your company, you get a more balanced picture.
- Be sure to assess your capabilities and resources in every area, from management to marketing to R&D to delivery.

- Strengths are strengths only if your capabilities and resources line up with the CSFs in your industry.

Analysing Your Situation in 3-D

You must be prepared to take advantage of your company's strengths and minimise your weaknesses, which means that you have to know how to recognise opportunities when they arise and prepare for threats before they overtake you. Timing is everything here, and it represents a third major dimension that you have to think about.

Chapter 4 discusses where major opportunities and serious threats come from. These dragons can come from almost any source and from all directions. They often change the rules of the game and can even alter CSFs that you assumed would always be part of your industry. Many opportunities and threats are the direct result of change (check out Chapter 12 if you don't believe us); others come directly from your competitors and the uncertainty that they introduce.

Taking a glance at competitors

Creating strengths-and-weaknesses grids for two or three of your most intense competitors is a great idea. (Turn to Chapter 7 for a look at exactly who your competitors are and what information you have about them.) You won't know as much about your competitors as you know about yourself, of course, so the grids aren't going to be as complete as they may be about your own company. But what you *do* know is going to tell you a great deal.

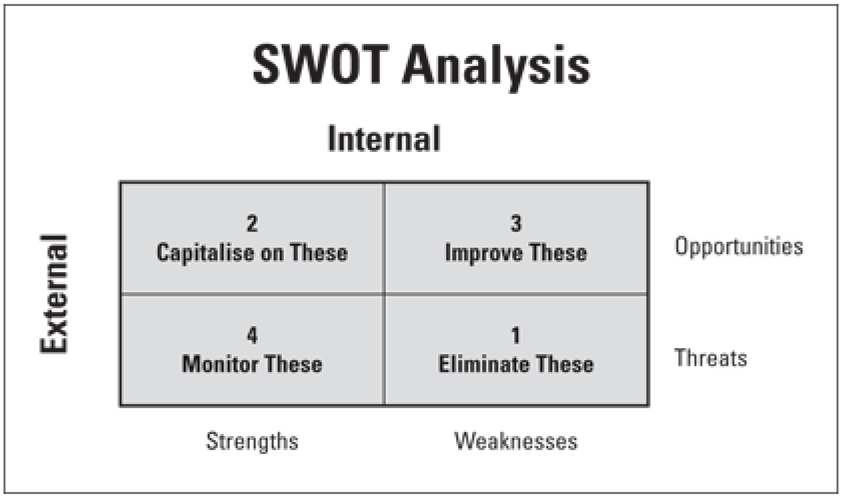
Comparing the strengths and weaknesses of competitors with your own can help you see where competitive opportunities and threats to your business may come from. Opportunities often arise when your company has a strength that you can exploit in a critical area in which your competition is weak. And you can sometimes anticipate a threat when the situation is reversed – when a competitor takes advantage of a key strength by making a move in an area where you're not as strong. Because the competitive landscape is always changing, plan to monitor these grids on a regular basis.

Completing your SWOT analysis

A SWOT analysis (an analysis of your strengths, weaknesses, opportunities and threats) allows you to construct a strategic balance sheet for your company. In the analysis, you bring together all the internal factors, including your company's strengths and weaknesses. You then weigh these factors against the external forces that you've identified, such as the opportunities and threats that your company faces due to competitive forces or trends in your business environment. How these factors balance out determines what your company should do and when you should do it. Follow these steps to complete the SWOT analysis grid:

1. **Divide all the strengths that you've identified into two groups, based on whether they're associated with potential opportunities in your industry or with latent threats.**
2. **Divide all the weaknesses the same way – one group associated with opportunities, the other with threats.**
3. **Construct a grid with four quadrants.**
4. **Place your company's strengths and weaknesses, paired with industry opportunities or threats, in one of the four boxes (see Figure 8-3).**

Figure 8-3: The SWOT grid balances your company's internal strengths and weaknesses against external opportunities and threats.



The SWOT analysis provides a bit of useful strategic guidance. Most of it is common sense. First, fix what's broken. Next, make the most of the business opportunities that you see out there. Only then do you have the luxury of tending to other business issues and areas. Be sure to address each of the following steps in your business plan:

1. **Eliminate any company weaknesses that you identify in areas in which you face serious threats from your competitors or unfavourable trends in a changing business environment.**
2. **Capitalise on any business opportunities that you discover where your company has real strengths.**
3. **Work on improving any weaknesses that you identify in areas that may contain potential business opportunities.**
4. **Monitor business areas in which you're strong today so that you won't be surprised by any latent threats that may appear.**

Change is the only constant in your business, your industry and your marketplace. Constant change means that you can't complete your SWOT analysis only one time; you have to revise the grid regularly as your company grows and as the environment around you changes. Think of your SWOT analysis as being a continuous process – something that you do repeatedly as an important part of your business-planning cycle.

A few things to bear in mind:

- To identify potential opportunities and threats, take a close look at the strengths and weaknesses of your competitors.
- A SWOT grid places your strengths and weaknesses in the context of opportunities and threats, and thereby tells you what to do.
- The SWOT strategy is to eliminate weaknesses in areas where threats loom and also to capitalise on strengths in areas where you see opportunities.

Measuring Market Share

In any competitive market there is typically a market leader, a couple of market followers and a host of businesses trailing in their wake. The slice each competitor has of a market is its *market share*. You find that marketing people are fixated on market share, perhaps even more so than on absolute sales. That may appear little more than a rational desire to beat the 'enemy' and appear higher in rankings, but it has a much more deep-seated and profound logic. The old saying 'success breeds success' applies here and winning the battle for market share gives a business a very important leg up.

Back in the 1960s, a firm of American management consultants observed a consistent relationship between the cost of producing an item (or delivering a service) and the total quantity produced over the life of the product concerned. They noticed that total unit costs (labour and materials) fell by between 20 per cent and 30 per cent for every doubling of the cumulative quantity produced.

So any company capturing a sizeable market share has an implied cost advantage over any competitor with a smaller market share. That cost advantage can then be used to make more profit, lower prices and compete for an even greater share of the market, or to invest in making the product better and so stealing a march on competitors.

A glance at Figure 8-4 provides a clue as to how Tesco can stay competitive, outgrow other players in the market and make a good return for shareholders.

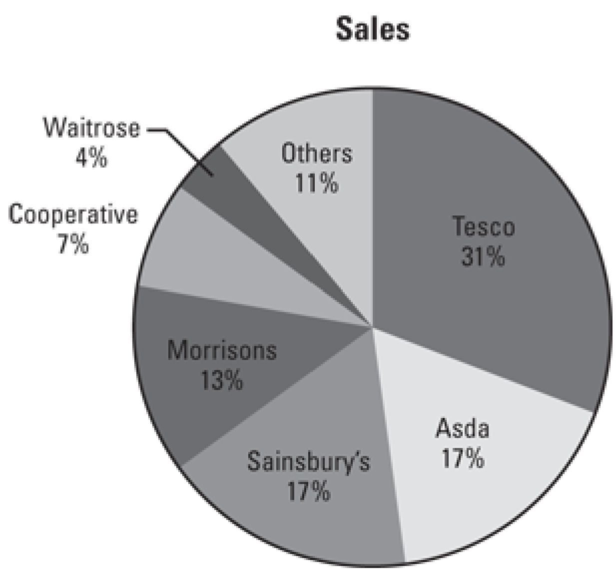


Figure 8-4: Market share of UK supermarkets in October 2011.

Chapter 9

Focusing On What You Do Best

In This Chapter

- Describing what your company does
- Constructing a value chain
- Searching for your competitive advantage
- Focusing on your company's core competence
- Sustaining a competitive advantage over time
- Using the value chain to allocate resources

Every time you leave the house to go shopping, you gear up to make a complex set of choices that together determine what you finally come home with at the end of the day. As you look down the shopping list over morning coffee, the decisions begin:

- Town centre shops or the out-of-town shopping precincts?
- Speciality shops or a department store?
- Designer brands or store labels?
- £25, £50 or £100 limit?

If you happen to be in the business of producing and selling products in shops, these are make-or-break decisions. How do shoppers make their choices? Why do they go into one shop and not the next? What determines where they stop to browse and what they take a second look at? How are customers different from one another? In what ways are they the same? No matter what industry you’re in, the same kinds of questions are just as crucial.

As they go about making decisions on what to buy and where to shop, customers continually weigh various combinations of product or service benefits against price. When customers make their choices based on their own calculation of the best value they can find in the marketplace, they’re using a *value equation*. (Check out Chapter 7 if you want to know more about that equation.) But what does it actually mean to have the best value out there? If you’re one of the competitors, you need to know exactly where and how your products add value in the eyes of your customers.

In this chapter, we take another look at how you create customer value around your own products and services. The approach is called a *value-chain analysis* by people who try to make something simple sound difficult, and we use it to identify which parts of your business are responsible for adding the greatest value for customers. We show you how to use your value chain to help explain why you may have a competitive advantage in the marketplace. We also use the value chain to point out your company’s *core competence*. We talk about how you can work to maintain your competitive advantage over the long term. Finally, we show you how to use an understanding of your value chain and core competence to make the most of your company’s human and financial resources as you create your business plan.

Describing What You Do

You'd think that it would be easy to describe what your company does, summarising your key business activities in a few well-chosen sentences or in a clear diagram or two. It's not. From the inside of your business looking out, it's much harder than you may think to push away the everyday details to get at the core of what actually keeps you in business from one day to the next.

That's why consultants hang around a lot. Many of them would like nothing better than to help you describe what you do. Their little secret, of course, is that they're not really any smarter than you are. Consultants seem to have a clearer view of your business simply because they're on the outside looking in.

But chances are that you've a built-in understanding of your own business and what really makes your company successful – you just need to unlock what you already know.

Tom Farmer, the son of a Leith shipping clerk who earned £5 a week, launched Kwik-Fit, a company that grew into a £418 million public company with almost 1,000 outlets, before he sold out to Ford for £1 billion. In his own words, the enduring philosophy behind his business to which he ascribes its success is '100 per cent customer satisfaction. Just giving service – phoning back in half an hour if you say you will, standing by promises – puts you miles ahead of anyone else in the field.' Knowing that service is as important as the exhausts themselves is what has provided Kwik-Fit with a lasting competitive advantage.

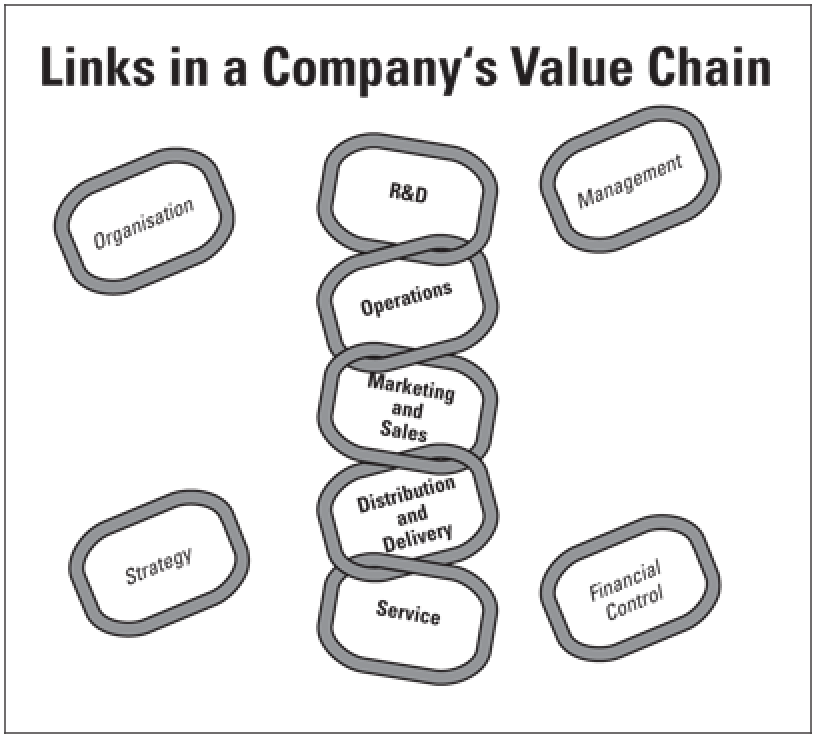
This canny businessman had a real feeling for why he was successful at what he did. Given a little guidance, you can take the same gut-level understanding of your own business and develop a chain of activities that captures what your company really does to stay in business. In particular, we focus on creating customer value, and divide your business into the specific areas and activities that build value into the products and services that you offer.

Kwik-Fit has been rather less successful under new ownership. French private equity firm PAI Partners bought Kwik-Fit in 2005 for £800 million, selling it on in March 2011 to Itochu, a Japanese conglomerate for just £637 million.

Constructing a typical value chain

Your company constructs its *value chain* from the sequence of activities that it engages in to increase the value of your products and services in the eyes of your customers. (See Figure 9-1.) The chain connects you to the marketplace, making sure that you don't stray too far from the customers you serve.

Figure 9-1: A company's value chain has two types of links: primary activities and support activities.



The links in a value chain help you to understand your company's activities.

Primary links in the value chain are the business functions that are at the heart of what your company does. Primary links are usually sequential. They're the essential stages that your company goes through in developing, producing and getting products to market and they often involve the following:

- Research and development
- Operations
- Marketing and sales
- Distribution and delivery
- Service

Supporting links in the value chain contribute to the overall success of the business by strengthening your company's primary links. Supporting links are often spread throughout your organisation. They assist and tie together all the primary business functions, as well as support one another. The activities often involve the following:

- Management
- Organisation
- Strategy and planning
- Financial control

Try to concentrate on organising your basic business functions around customer value and the bright idea that everything you do in your company should somehow contribute to that effort. A value-chain analysis allows you to take your company apart and put it back together, making sure that each link in the chain contributes to the value that customers see when they buy your product or service.

Comparing different value chains

You can find out a great deal about a company by checking out its value chain: where and how the company creates customer value. In fact, the value chain is a relatively good way to compare and contrast competitors in your own industry. You may even want to use this information to revisit your strategic groups of competitors. (See Chapter 7 to find out what the phrase *a strategic group of competitors* means.)

To see how to compare value chains, take a closer look at the airline industry. The experience of flying from London, Heathrow to Belfast, for example, is usually measured somewhere in the range of tolerable to terrible. Air travel always seems to generate metaphors that involve cattle trucks, the underground at rush hour and Guinness records that have to do with people crammed into telephone booths or Volkswagens. But within these constraints, so to speak, airlines do in fact compete for your sky business in different ways.

Ryanair and easyJet, for example, are major players in the so-called ‘budget’ segment. Compared with other airlines, these companies can make several additional flights a day in each airplane, based on their capability to turn the plane around – unload, reload and take off – in about 20 minutes. Most of the costs in the airline industry are tied up in things such as aircraft and buildings, so extra flights a day mean extra profits for an airline – or lower prices for customers. These companies cater primarilly to people who have to pay for travel out of their own pockets and are looking for the best deal. How do budget airlines make their businesses work? A quick glance at easyJet’s value chain highlights several important value-adding activities. Key links include:

- **Operations:** Budget airlines have efficient personnel, ace ground crews and state-of-the-art equipment that allow them to get planes in and out of airports as fast as humanly possible, meet tight flight schedules and reduce overall costs.

- **Distribution:** These airlines have built up regional route systems that tend to bypass the most crowded airports and overly competitive destinations. Periodic reviews of passenger traffic and competition suggest expansion opportunities that are in line with the carrier's low-cost strategy.

- **Management:** They have put together teams of managers and professionals who have the skills, aptitude and temperament to deal with considerable job stress and who work well together.

By contrast, British Airways is a global, full-service carrier at the opposite end of the airline spectrum from the budget crew. The company serves hundreds of destinations daily and offers frequently scheduled flights to most major commercial airports in the world.

Its extensive national network feeds into international routes that span the globe. BA has a freephone reservations number, close relationships with travel agents, a frequent-flyer programme offering worldwide awards and credit cards tied to its mileage programme. Customers count on BA to provide in-flight meals on longer flights, films, to transfer their bags and to cater to them if anything goes wrong along the way. Who are these customers? Many of them are business passengers and other well-heeled travellers who are willing to pay the price to cover the costs of all these added services.

Although getting each plane turned around quickly on the ground certainly is important to British Airways, the company doesn't depend on it the same way that easyJet does. In fact, the services that BA's passengers demand make it almost impossible for its airline crews to keep up with easyJet on the ground. BA's value chain points out the areas in which the airline adds customer value. Key links include the following:

- **Research and development:** Whether developing more comfortable business-class seats, better in-flight entertainment, or Internet connections at 35,000 feet, British Airways works to please its most demanding customers. At the same time, its reservation system and yield-management software allow the airline to maximise revenue and match fares with other airlines in certain competitive markets.

- **Marketing and sales:** The company spends significant time and resources in promoting its image and worldwide brand. BA advertises in a wide range of global media, sponsors all sorts of special events and maintains strong ties with travel agencies across the country and the world.
- **Service:** Customer service is a major link in BA's value chain. The company makes every effort to create a lasting relationship with its most loyal customers through its frequent-flyer programme. And it makes sure that these valued customers are pampered with special airport lounges, hassle-free check-in and checked baggage that always arrives first in the baggage claim.
- **Financial control:** British Airways maintains the financial resources and flexibility to fund continued investments in the extensive ground facilities and huge fleet of aircraft that allow it to serve a global network of routes and destinations.

Both easyJet and British Airways are in the business of transporting passengers from one location to another by using aircraft on regularly scheduled flights, yet their value chains and the important links in creating customer value are quite different.

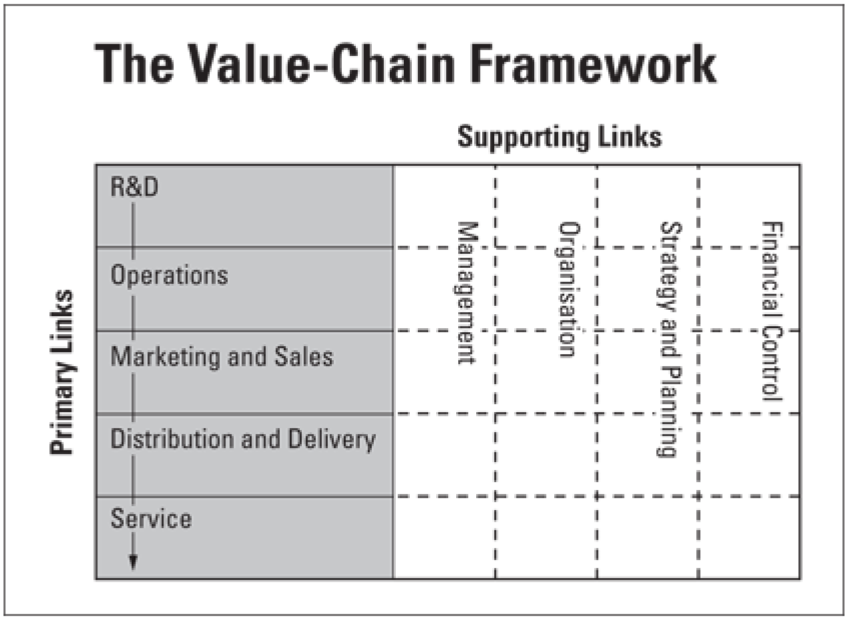
Value chains don't stand still. In April 2011, Ryanair introduced seat reservation on some flights, aimed at smoothing the travel experience for business flyers. Earlier in the year they opened a Business Lounge at Stansted offering wi-fi, printing, scanning and fax facilities as well as bar and bistro. In September 2011, easyJet enhanced its Flexi Fare ticket, introduced to give business travellers benefits such as speedy boarding, unlimited ticket changes and one piece of hold luggage, to include an offer to those whose arrivals are delayed by more than 15 minutes of a free leisure ticket to anywhere on easyJet's network.

Forging your own value chain

To develop your company's own value chain – the sequence of activities that you go through in the process of adding customer value to your products and services – you need a list of your company's capabilities and resources. Take a look at Chapter 8 if you need help.

You can construct a framework for your value chain by creating a grid that divides your business into value-creating areas (see Figure 9-2). Then you place activities in the grid based on whether they're part of your primary business functions or are associated with supporting areas.

Figure 9-2: The value-chain framework.



Follow these steps to create the grid that shapes your value chain:

1. **List all the key business areas that are directly involved in putting together your own company's products and services and getting them out to customers.**

   Include such things as R&D, operations, marketing, sales, distribution, delivery and service.

2. **Arrange the list of key business areas in order, from the first good idea out of R&D to the finished product or service.**

3. **List the general business areas in your company that support the primary business functions.**

   Include such things as management, organisation and human resources, strategy and planning, and financial control.

4. **Construct a grid similar to the one in Figure 9-2, using your own lists of primary and supporting business areas.**

Your value chain may not look exactly like all those organisation charts that are floating around your company. The primary and supporting business functions that end up adding customer value may be framed differently, depending on whom you ask, so make sure that you talk to customers as well as to co-workers. Ask your customers to describe your business as they see it. Your customers just may have a better vantage point.

A blueprint for change

An architectural and engineering firm in the northeast, that we'll call NAE, used to pride itself on being a full-service building consultant. Its professional staff ranged from structural engineers to interior designers and everyone in between. The company maintained a complete project-budgeting department and a full in-house blueprinting operation; in fact, the firm routinely turned down requests by small outside contractors to take over and supply blueprinting services. Business was booming, the company was growing and its clients couldn't have been happier.

All that changed in 2008. A major and sustained downturn in the property market hit NAE quite hard, and the company was forced to think about ways to cut costs as its very survival was at stake. As part of the restructuring effort, NAE took a hard look at its internal blueprinting operations, and it discovered that it should have taken the bids from outside suppliers more seriously. Independent contractors could provide the quality and reliability that NAE demanded and substantially lower the firm's blueprinting costs at the same time.

When NAE asked its most important customers what they thought about the proposed changes, the answers were surprising. No one chose the company because of the quality of its blueprints; clients saw real value in the breadth and expertise of the company's professional staff. By reviewing the value chain, NAE had an opportunity to refocus its resources and energy on the activities and links in the chain that provided the most value to its customers. Doing so also helped it to stay afloat while less observant competitors sank without trace.

To fill in the value-chain grid, you have to fill in all the specific value-adding activities – the capabilities and resources that your company uses to increase the value of your products and services in the eyes of your customers. Follow these steps:

1. **Go through the lists of capabilities and resources, and have a first go at placing them in the value-chain grid.**
2. **In the boxes on the left side of the value-chain grid, place value-adding activities that directly contribute to your primary business functions.**

   These activities make up the primary links in your value chain.
3. **Place value-adding activities that are associated with supporting functions in grid boxes across from the primary functions that they support.**

   These activities are the supporting links in the value chain.
4. **On the grid, include a description of the customer value that's added at each link, as well as how that value is added.**

The value chain offers you a unique look at your company through your customers' eyes. Every link in the value chain is something that you do as a company. Every link is an activity that you spend money on. The value chain allows you to see exactly what value customers are getting out of each link. A value-chain analysis gives you a relatively clear picture of why you stay in business, as well as where you can be doing a better job.

A few things to remember about the value chain:

- The value chain describes all the things that you do to add value to the products and services that you offer customers.
- Value is in the eyes of the customer.
- By comparing the value chains of other companies in your industry, you find out about the competitive landscape and how you fit in.
- A value chain shows exactly what value your customers are getting from each of your basic business functions.

Staying in Business

Companies don't just stay in business year after year by accident. Oh, maybe a manager somewhere gets lucky every once in a while, making a brilliant move without having a clue as to why the move is so brilliant. But that kind of luck never lasts long, especially when the competition is intense. Companies succeed over the long haul because they understand what their customers place the most value on, and they translate that knowledge into products and services that consistently meet or exceed customers' expectations, often at the expense of unsuspecting competitors.

Using a value chain for your own company enables you to pinpoint the business areas and activities in which most of your customer value is created. Those key areas and activities tell you about your company's advantage in the marketplace and how it achieved that advantage. The value chain may highlight the importance of your cost advantage in the market, for example, and point out that your company achieved that advantage through careful, continuous improvements in manufacturing efficiency. Or maybe your value chain flags the calibre of your professional staff as being a key advantage in the marketplace, achieved through a commitment to recruit, develop and support the most capable people out there.

Take a close look at what it means to have an advantage over the competition in your marketplace, where the advantage comes from, and how you can work to maintain it over the long haul.

Searching for competitive advantage

We all know people who like to take car trips – maybe up to the Lake District for a walking weekend or off in the family caravan whenever the weather's nice. If you ask them where they stop along the way, they always have a special burger van, a favourite pub or café, or a certain ice-cream place that they would never dream of missing. Why do these travellers develop such affection for specific stops on their route when hundreds of other places are available along the way? What makes particular establishments so unique?

If you push them, these travellers come up with all sorts of reasons. They may tell you that they've been stopping at the same places for years, that they love the food, that they like the atmosphere, that they know the owners, that they can count on the service . . . whatever. No doubt all these things are true. But take a careful look at the value chain for many of these businesses, and one important link that jumps right out at you is likely to be location. Distances and driving times most likely are the major reason why many of their customers find these businesses in the first place; the shopfronts literally happen to be in the right place at the right time. Location provides a significant competitive advantage in this on-the-move marketplace.

Competitive advantage means exactly what it says: a company has some sort of advantage over the competition. Where does it come from? Usually, out of the distinct and special value that the company can offer its customers – and from the premium that customers place on that value. Ask yourself this basic question:

Why do customers choose my company and its products when other competitors in the industry have more-or-less similar offerings?

You can find the answer in the strongest links of your value chain. The links that produce the bulk of your customer value – whether this value is location, service, image or product features – are the links that create your competitive advantage in the marketplace.

In the beginning, Microsoft was a partnership of two: Bill Gates and Paul Allen. They started out competing against a host of bright young entrepreneurs like themselves and eventually had to go head-to-head with IBM itself. Today, Microsoft has over 20,000 employees and $5.18 billion in revenue and offers a wide array of software products, ranging from word processing programs and spreadsheet applications to language tools and operating systems. Its Windows program alone has sold more than 100 million units. Microsoft's competitive advantages:

- **Standards:** Microsoft's programs pretty much set the standards in the PC world. Microsoft offers the standard operating system and the standard suite of office applications. Although other companies sell better products here and there, Microsoft is seen as being the safe and sensible choice across the board.
- **Compatibility:** Microsoft programs promise to work with one another and with the operating system. You don't have to worry that your favourite application will become an outcast or somehow misbehave inside your computer.
- **Product range:** You name it, and Microsoft probably has a product that can do it. The company continues to aggressively develop new software to meet the needs of rapidly changing markets. Most recently, the company targeted Internet users with a host of new products.
- **Service and support:** With Microsoft, you know what you're getting. If something doesn't work, the company tries hard to fix it. In the meantime, it's comforting to know that you can always find other people who have the same problem.

Hertz is by far the largest car-rental agency in the world. The company has rental locations in more than 150 countries and boasts a fleet of more than 500,000 vehicles. But Hertz faces competition at all levels, from the family-run rental companies at popular holiday spots to regional agencies such as easyCar, an offshoot of easyJet and other global companies, including Avis and National. Hertz Corporation's competitive advantages:

- **One-stop reservations:** When you call the Hertz free number, you gain immediate access to the company's worldwide fleet. You can quickly and conveniently book the kind of car that you want, when and where you want it. Changing your mind is just as easy.
- **International presence:** No matter where or why you need the car – for a safari in Africa, a tour of Italy, or a business trip to Birmingham – you can safely bet that Hertz can rent you what you need.
- **Peace of mind:** With Hertz, you don't have to worry that the car won't be there, that the rate going to double, or that you'll end up paying for a rent-a-dent that's obviously a year old. Also, to help you find your way around, the company offers personalised maps and is introducing a new onboard navigation system.
- **Rewards for loyalty:** As a loyal Hertz customer, you're rewarded with membership in a club that provides extra service, attention and the chance to apply the pounds that you spend toward free rental days.

Biggest is useful, but best is better According to a survey in October 2010 by Condé Nast Traveler, Hertz, Enterprise, and Avis top the list of best car hire firms. The results take into account rates, reliability and locations. But to stay at the forefront of new developments in the industry, Hertz recently intoduced one-way rentals allowing customers to drop off a car at an airport instead of an original pick-up spot, a valuable benefit for business users. Enterprise and Avis, on the other hand, are pioneering electric car rentals, appealing to the green and cost conscious markets.

Focusing on core competence

Your competitive advantage is created in the marketplace. That advantage has everything to do with your customers, with the relative value that they place on your products and services, and with the purchase decisions that they finally make. But what is it about your company that allows you to achieve this competitive advantage? What internal capabilities and resources do you have, and what business activities do you engage in that lead directly to your competitive advantage?

You probably already have the answer. Go back to your company's value chain, and focus on those links that are most responsible for your own competitive advantage. When you do, you come face to face with something that the gurus call your core competence. Simply defined, *core competence* is your company's special capability to create a competitive advantage for itself in the marketplace. In almost all cases, this gift is specific to your company. Think of core competence as being corporate DNA. Unlike your personal genetic code, however, your company's core competence is there for you to build on – or to lose, depending on how attentive you are to your markets and your business.

The section 'Searching for competitive advantage' earlier in this chapter examined two well-known companies, each of which is a household name. Can you identify the core competence behind that competitive advantage for both Microsoft and Hertz?

Microsoft's core competence is built on:

- **Visionary executives:** The executive team has a broad vision of the future, enabling the company to forge today's software standards and shape tomorrow's.
- **Top-notch development team:** The company is committed to supporting a dream-team corps of developers and programmers who are charged with creating and maintaining a state-of-the-art product line.
- **Management of complexity:** Microsoft manages a complex related set of software products that all have to behave and work together.
- **Capability to change direction:** The company has the capacity to redirect resources and energies when the fast-moving marketplace shifts course and the rules of the game suddenly change.

Hertz Corporation's core competence consists of:

- **Information systems:** A sophisticated computer database allows the company to keep track of customer profiles and match them against an ever-changing supply of rental cars around the world.

- **Global logistics:** The company has the capability to track, distribute, arrange and rearrange a huge fleet of vehicles in all shapes and sizes on a worldwide basis.
- **Scale of operations:** The company uses its sheer size and business volume to negotiate favourable terms when it comes to new-car purchases and even insurance premiums.
- **Relationships and tie-ins:** Hertz has the resources to work closely with travel agencies and the travel industry to create new business by expanding car-rental options and opportunities.

Sometimes, a company's core competence can point the way toward new market opportunities. Honda, for example, used a core competence in designing engines to expand its markets. The company created product lines in lawn mowers, snow throwers, snowmobiles and all-terrain vehicles, to name just a few of its motor-based businesses. Honda benefits from a related competitive advantage in each of these distinct markets. Take another look at your own company's core competence to see whether you can come up with any new business directions, based on those things that you already do well.

Sustaining an advantage over time

Every company that manages to stay in business from one month to the next has some sort of competitive advantage and core competence to draw upon; otherwise, it simply wouldn't be there. But the million-dollar question has to do with how to renew and sustain that competitive advantage over years and even decades. Customers and their needs shift over time, competition gets more intense and industries evolve, so your competitive advantage and the core competence that supports it aren't guaranteed to stay around. You rent them; you don't own them. You want to make sure that you keep a long-term lease on both.

Sustained competitive advantage – the business world's Holy Grail – is a company's capability to renew a competitive advantage over and over again in the face of a constantly changing business environment and marketplace. But if you want to sustain a competitive advantage over time, you need to have a long-term strategy in place. Chapter 7 introduces three common alternatives called generic strategies and gives you a handle on what your competitors may be up to. Chapter 13 takes a much closer look at your own strategic options.

Spend time thinking about things that your company can do on an ongoing basis to see that your core competence is preserved or evolves to meet changed market needs. How can you sustain the competitive advantage that your company already has? Get a blank sheet of paper and jot down answers to these key questions:

- Where will changes in your business most likely come from?
- How are those changes likely to affect your company's competitive advantage?
- What can your company do to maintain core competence in the face of change?

Focus on each of the major forces that fuel change in your own industry:

- Your customers and their changing needs and requirements.
- Your competitors and their changing capabilities, strategies and goals.
- Your company, its value chain and its shifting strengths and weaknesses.

As you create your business plan, make sure that you continue to track these forces so that they don't threaten the core competence you've worked so hard to achieve or so that your core competence evolves.

Sounds like a summary is in order:

- Your core competence – what sets you apart – is based on the strongest links in your value chain.
- Competitive advantage in the marketplace is a direct result of your company's distinct core competence.
- Staying ahead of the competition means sustaining your competitive advantage, which requires a long-term strategy.

EXAMPLE

Whatever happened to Daddy's Daimler?

Daimler used to be a synonym for *making it* in the UK. When a Daimler was parked in front of someone's house, it meant that they had finally arrived. In fact, you'd have been hard pressed to think of another product that could bestow quite as much status on its owner.The car was built for ultimate comfort, and it conveyed an image of wealth and luxury. Daimler owners were an intensely loyal bunch, typically ordering new models every few years, just to burnish that image.

Dailmer owners are still loyal today, but not to that brand. In the 1980s, a new generation of car buyers began to look for new status symbols. The young and wealthy began to chase foreign cars with names such as BMW, Mercedes and Volvo (or Lexus, Infiniti and Acura). Whatever happened to Daimler's enviable position in the luxury-car market? Competition, of course, and a failure on Daimler's part to respond quickly to changing tastes. The image of luxury and intense brand loyalty that the car used to enjoy simply weren't passed along to the next generation of buyers, and a once-powerful competitive advantage quietly slipped away.

Earmarking Resources

The value chain paints a portrait of your company as your customers see it. Links in the chain reflect the value that customers place on aspects of your products and services. The strongest links capture your competitive advantage in the market and define your core competence as a business. Because the value chain is so good at weighing the importance of the things that your company does, it also comes in handy when you plan how your resources are going to be used.

Have you ever been to a horse race? If you have, you know that you're bound to see a group of regulars hanging around the stands or clustered at the fence. These people are serious about horse racing. They spend time poring over form sheets and newspapers, circling this, checking that. They pace back and forth, occasionally disappearing for a while to do something or other. What are they up to?

Well, they're placing bets, of course. But they're certainly not relying on Lady Luck alone to keep them flush. Instead, they're using all the information available – the condition of the track, the horse's health, the jockey's record and the betting odds – to place their cash only on those wagers that are most likely to result in the best payoffs and the biggest winnings.

Betting on the horses is a serious business for these committed professionals. Maybe those punters can tell you something about how to divvy up working assets. Is it sensible to spread your company's limited resources equally among all the areas that make up your business? Probably not. Each time you set aside time and money for a particular business activity, you're placing a bet. What you're betting is that the resources you commit are going to contribute to your business, add value to what you do, and eventually come back around to generate revenue and profits.

Chapters 10 and 11 help you pore over the numbers (financial statements, ratios and budgets) that keep track of where you spend money and then tell you whether you're winning. In short, your financial statements tell you a great deal about how you manage your cash, what bets you place and how well you do at the track. But your financial statements alone don't tell you *what* to do. So how do you know where to place your bets in the first place?

AHEAD OF THE PACK

You guessed it: you go back to your company's value chain. Consider this simple way to check your resource allocation based on your own value chain:

1. **Look at where your company currently spends money.**

   Make a quick-and-dirty estimate of how yearly expenses are divvied up among business activities – from R&D to delivery and service – and jot the numbers down on your value-chain grid. To keep things simple, use percentages. Make sure that the numbers add up to 100 per cent.

2. **Look at where customers think that you're providing them value.**

   Take the total value that customers think you provide, and divvy it up among your business activities. If customers pay £100 to buy your widget, for example, how much of that are they willing to pay for features, how much for service and how much for convenience? Again, use percentages, and jot the numbers on the same value-chain grid. Make sure that the numbers add up to 100 per cent.

3. **As a reminder, highlight the boxes on the value-chain grid that represent your core competence and account for your competitive advantage in the marketplace.**

4. **Analyse the completed grid.**

   If the percentages line up and are concentrated in the highlighted boxes, you're in fairly good shape. But if you find a glaring mismatch in terms of where you're spending money, what your core competence is, and where your customers think that your products get their value, take time to reassess where your company's resources are directed.

The value chain is invaluable when it comes time for you to earmark resources for your business activities. A clear understanding of your core competence and competitive advantage helps you make informed decisions when you have to allocate scarce resources.

Check out these points about the value chain:

- Value chains come in handy when it comes to planning the best way to allocate your company's resources.

- A value chain highlights mismatches between current spending and the areas that provide the most value to customers.

Chapter 10

Figuring Out Financials

In This Chapter

- Understanding a profit and loss account
- Interpreting the balance sheet
- Examining cash flow
- Evaluating financial ratios

Numbers. Some people love them; others are bored by them; still others begin to stammer, shake and exhibit other physical signs of distress around them. But almost everyone agrees that, love 'em or hate 'em, numbers are the way that we keep track of things – football, cholesterol, the stock market and our latest business venture. There's a lot more to numbers than simply the score at the end of the game or the final Footsie closing, however. When they're put together in the right ways, numbers paint detailed pictures and tell stories about everything from the career of a football player to the state of the global economy.

You're probably familiar with the numerical snapshots that a bank requires when you want to borrow money for a new car, a bigger house, or the caravan in Devon that you've always wanted. Those snapshots always include a profit and loss account, as well as some sort of balance sheet. The profit and loss account tells the bank where you get your money and where you spend it. The balance sheet lists the value of all the things that you own and balances it against the money that you owe, including your car loans, mortgages, credit cards and even personal IOUs.

Financial statements tell the bank a great deal about you, and the bank learns even more by taking numbers from the statements and calculating a load of ratios. The bank totals your monthly loan payments and divides that number by your monthly income, for example, and then compares this ratio with the average for other borrowers. The result gives the bank a relatively good measure of your ability to repay the loan. Taken together, the statements and ratios create a financial portrait that the bank uses to get to know you better. And the better the bank knows you, the more reliable its decision is.

In this chapter, we introduce the basic financial statements and ratios that are widely used in business planning – which really are the same ones that paint a picture of your personal finances. First, we show you how a profit and loss account and a balance sheet are put together. Next, we explain cash-flow statements, which do pretty much what the name implies. Finally, we explore simple financial ratios that you can use to evaluate your business.

Understanding a Profit and Loss Account

A *profit and loss account* presents the proverbial bottom line. By adding all the revenue that you receive from selling goods or services and then subtracting the total cost of operating your company, the profit and loss account shows *net profit* – how much money the company has made or lost over a given period. Here's how to think of net profit:

Net profit = Revenue – Cost

The important thing to remember is the fact that the profit and loss account captures a simple idea. No matter what your accountants call it – a profit and loss account, earnings report or statement of profit and loss – or how complicated accounting types make it look, it still uses the same basic principle of subtracting cost from revenue to come up with profit.

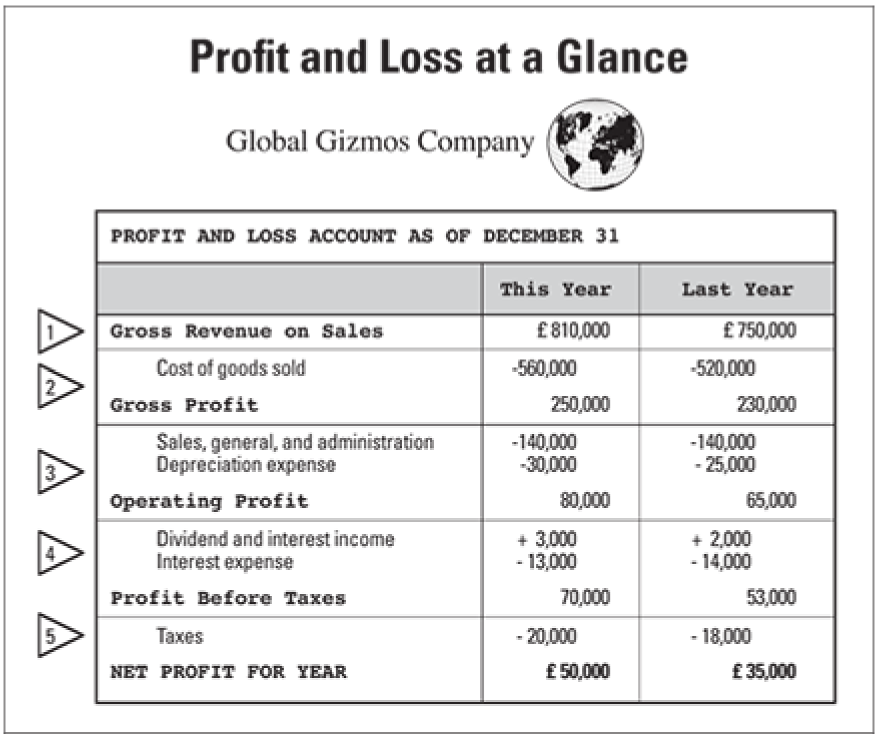
Your profit and loss account should cover a period that makes the most sense for your business planning: monthly, quarterly or yearly. (The tax people, of course, are always interested in seeing your profit and loss account once a year.) You get a better financial picture of your company and where it's going if you look at profit and loss accounts over several periods and even over several years. In Chapter 11, you develop a pro-forma profit and loss account – a forecast of your profits based on projected revenue and costs.

Look at the various parts of a profit and loss account for Global Gizmos Company (see Figure 10-1). Notice that Global Gizmos includes a two-year comparison to show how revenue, costs and profits have changed over time. Global Gizmos is a small company; if you want to make it a big company, add three zeros after all the numbers. In either case, the profit and loss account works exactly the same way.

Revenue

JARGON ALERT

Revenue refers to all the money that a company receives as a result of being in business. The most important source of revenue (usually, the sale of goods or services) always appears as the first item in the income statement – in the case of Global Gizmos, gross revenue on sales. In this context, *gross* doesn't mean anything unpleasant; it indicates that the revenue is a total, without costs subtracted. Revenue from sources other than sales usually shows up a bit later in the profit and loss account.



PROFIT AND LOSS ACCOUNT AS OF DECEMBER 31		
	This Year	**Last Year**
Gross Revenue on Sales	£ 810,000	£ 750,000
Cost of goods sold	-560,000	-520,000
Gross Profit	250,000	230,000
Sales, general, and administration	-140,000	-140,000
Depreciation expense	-30,000	- 25,000
Operating Profit	80,000	65,000
Dividend and interest income	+ 3,000	+ 2,000
Interest expense	- 13,000	- 14,000
Profit Before Taxes	70,000	53,000
Taxes	- 20,000	- 18,000
NET PROFIT FOR YEAR	**£ 50,000**	**£ 35,000**

Figure 10-1: The profit and loss account starts with gross revenue and then subtracts the costs of various business activities to arrive at different kinds of profit.

Gross revenue on sales

Gross revenue on sales is based on the number of units actually sold during a particular period multiplied by the prices actually paid. Global Gizmos sold 32,400 widgets at a price of £25 each, for a gross revenue of £810,000. Things can be a little more complicated than this example, of course; your company may have several products or kinds of service, or your prices may change over time. Maybe you have to make an allowance for items that are returned. All these considerations contribute to your own calculation of gross revenue on sales.

Dividend and interest income

Your company may have sources of revenue besides sales – the income from savings accounts and other securities, for example. Because you must have money to operate the company anyway, you probably want that money to make money while it's sitting around. You should keep this investment income separate from your revenue on sales, however, so that you always know how much money the company itself is generating. In your profit and loss account, your dividends and interest income should appear separately from your other revenue.

Costs

Unfortunately, you have to spend money to make money. The cost of doing business usually is divided into general categories that reflect the separate activities that a company is involved in and the different kinds of expenses that it incurs. Major cost categories include cost of goods sold, sales and administrative expenses, depreciation, interest expense – and don't forget taxes. Each item deserves its own entry in the profit and loss account.

Cost of goods sold

JARGON ALERT

The *cost of goods sold* (COGS) combines all the direct costs of putting together your product or service. Raw materials, supplies and the labour involved in assembling a product are all part of the COGS; so are the electricity, water and gas used in manufacturing, as well as the costs of maintaining production facilities. If you offer dog-walking for pet owners, for example, the costs associated with delivering that service – leads and pooper scoopers – go into the COGS.

You may have to make a judgement call here and there about what is or isn't part of the COGS. Just remember to be consistent over time.

Sales, general and administration

Sales, general and administration expenses (SG&A) combine all the costs associated with supporting your product or service. If the company is just you, a telephone and a tiny rented office above the hardware shop, the costs won't amount to much. But for larger companies, these costs seem to go on and on. SG&A includes salaries and overheads for the sales staff as well as the receptionist, secretary and the boss. SG&A also includes advertising and promotion, travel, telephone calls, accounting fees, office supplies, dues and subscriptions and everyone's favourite, miscellaneous expenses.

SG&A costs are tracked separately because they're not tied directly to revenue and can easily get out of hand. Make sure that you keep an eye on this particular entry.

Depreciation expense

Depreciation expense is a standard way to spread both the cost and the usefulness of expensive items out over time. Whether a building, a truck, or a computer, almost any durable item that your company buys slowly declines in value, because of simple wear and tear or because new technology makes the item obsolete. Bean-counters have come up with various ways to calculate that depreciation. All the methods allow you to allocate a portion of the purchase price as a business expense each year, to reflect a decrease in value. (Land, by the way, isn't included in depreciation expenses and can't be depreciated.)

Interest expense

Interest expense includes all the money that you pay out to the parties that loaned you funds to operate the company. You don't want to overlook this cost. You may have entered into agreements with banks or other investors, for example, and are obligated to pay back interest on a fixed schedule. An interest expense (often called a *fixed charge*) is isolated in the profit and loss account because it absolutely, positively has to be paid year after year.

Taxes

Even Albert Einstein stopped short of trying to figure his own taxes. But taxes are a fact of life and represent another cost of doing business. You can minimise your company's taxes by making sure that you keep careful track of all your other expenses.

Profit

Profit is the Holy Grail. When you do things right, the total costs flowing out of your business are less than all the revenue coming in. Your profit, of course, represents the difference. But it's useful to talk about different kinds of profit at various stages along the way. In particular, you can keep track of gross profit, operating profit and profit before taxes, as well as your overall net profit. Comparing profit at different stages gives you a clearer picture of where your company is most efficient and where you can do better.

Gross profit

JARGON ALERT

Gross profit measures how much money your company still has after you subtract all the direct costs of putting together your product or service (COGS) from the total revenue generated by sales. This profit doesn't include the many indirect expenses that you have in running the company or any revenue sources other than sales.

Operating profit

JARGON ALERT

Operating profit accounts for all those additional sales, general and administration (SG&A) costs that you incur as part of operating your business; it also subtracts the depreciation expense of your costly purchases. Operating profit reflects the money that you make from your overall business operations.

Profit before taxes

JARGON ALERT

Profit before taxes takes everything else into account, including any financial transactions that you make. Your income from other sources (such as investment dividends and interest) is included here, as well as your interest payments to creditors.

Net profit

Net profit, of course, is the bottom line after the company's tax bite is subtracted. Global Gizmos made money in its most recent period.

Sounds like we need a summary of all this:

- A profit and loss account begins with your revenue and subtracts all your costs to come up with net profit, usually for a year.
- Revenue includes all the money that you take in from sales, as well as income that you receive from dividends and interest.
- Your costs include the cost of goods sold; sales, general and administrative expenses; depreciation; interest expense; and taxes.
- By calculating profit at various stages – gross profit, operating profit and profit before taxes – you can see precisely where the money comes from and where it goes.

Margins matter

Profit is the way you keep the score in the business game so clearly a high figure is better than a lower one. But that begs the questions what exactly is high? One way to keep track is to measure the profit relative to the level of business activity. So, for example, if the gross profits are £10 and the sales turnover is £100 the gross profit margin is 10 per cent (10 ÷ 100 x 100). If last year the gross profit was £5 and the sales turnover was £50, the gross profit margin was 10 per cent per cent also, meaning that while the amount of profit has doubled so has the activity required to make it. That doesn't mean the profit growth is not worth having, just that it would have been even better if we had, say, only had to have a turnover of £80 to make that £10 gross profit. Had we done so, our gross profit margin would have been 12.5 per cent (10 ÷ 80 x 100), a much better result than 10 per cent.

You can do the same sum for operating profit, and for profit before and after tax. Measuring margins in this way is particularly useful as it allows you to compare profit performance in a meaningful way irrespective of the size of the organisation. We look at this in more detail, and at some other useful financial relationships, later in this chapter in the section 'Evaluating Financial Ratios'.

Building the Balance Sheet

Whereas a profit and loss account captures the financial results of your operations for a given period, a *balance sheet* is more like a snapshot of your financial condition at a particular moment. The profit and loss account lists your revenue, your costs and the profit that you make. The balance sheet, on the other hand, addresses what your company owns, what it owes and what it's worth at a given moment. Ideally, the balance sheet tells you just how much money you'd have left over if you sold absolutely everything and then paid every last one of your debts.

The things that your company owns are called *assets* by the same people who look forward to audits and dream about accounting standards. The amounts that you owe make up your *liabilities*. The difference between the two represents the *equity* in your business. Think of equity in terms of the following equation:

Equity = assets – liabilities

Settling on layout

The balance sheet is laid out in a particular manner – an example is shown in Figure 10-2 below.

In this layout, we start with the *fixed assets*, land, buildings and equipment and work our way down. After the fixed asset sum has been calculated, we arrive at the residual unwritten down 'value' of those assets, tangible (land, buildings and so on), and intangible: in this case £295,000. We then work our way down the current assets in the reverse order of their ability to be turned into cash. Don't ask why things are done this way, they just are. Actually, it doesn't really matter a jot which order things come in as long as they're slotted into the right section of the balance sheet. The total of the current assets comes to £320,000.

Next we get the *current liabilities*, which come to a total of £140,000, and take that away from the current asset total to come to a figure of £180,000.

The sum left over after deducting the current liabilities from the current assets is the *net current assets*. This amount is often referred to as the *working capital*, as it represents the money circulating through the business day to day.

By adding the *net current assets* (working capital) of £180,000 to the total fixed assets of £295,000 – bingo: we can see we have £475,000 tied up in net total assets. Deduct the money we owe long term, the creditors due over one year, a fancy way of describing bank and other debt other than overdraft, and we arrive at the net total assets. Net, by the way, is accountant-speak for deduction of one number from another, often adding a four-figure sum to the bill for doing so.

The net total assets figure of £385,000 bears an uncanny similarity to the total of the money put in by the owners of the business when they started out, £155,000, and the sum they've left in by way of profits undistributed over the years, £230,000. So the balance sheet balances.

Figure 10-2: The UK balance sheet.

Fixed assests	*£s*	*£s*	*£s*
Land	60,000		
Buildings, equipment, machinery	355,000		
Less accumulative depreciation	125,000		
Net book value		290,000	
Intangible (goodwill, patents)		5,000	
Total fixed assets			295,000
Current assets			
Pre-paid expenses	5,000		
Stock	115,000		
Debtors	135,000		
Investments	35,000		
Cash	30,000		
Total current assets		320,000	
Less current liabilities			
Creditors	60,000		
Accrued expenses payable	80,000		
Total current liabilities		140,000	
Net current assets			180,000
Total assets			475,000
Less creditors, amounts falling due in over one year			90,000
Net Total Assets			385,000
Financed by			
Share capital	155,000		
Reserves (retained earnings)	230,000		
Total owner's equity			385,000

Let's look in a little more detail at assets and liabilities as these are the building blocks used to construct the balance sheet.

Assets

JARGON ALERT

Your company's *assets* include anything and everything you own that has any monetary value. When you think about your assets in terms of the balance sheet, all that you're concerned about is how much each asset is worth and how quickly it can be sold. So assets are separated into categories, depending on how *liquid* they are – how fast and easy it is to liquidate them, turning them into cold, hard cash. *Current assets* are those that you can dispose of within a year, if you have to, whereas *fixed assets* often take much longer to get rid of. *Intangibles* may never be converted to cash.

Current assets

Current assets represent your company's readily available reserves. As such, they're the assets that you draw on to fund your day-to-day business operations, as well as the assets that you may have to turn to in a financial emergency. Current assets include the following:

- **Cash:** You can't get any more liquid than cash, which is just what you expect it to be: notes and coins in the till, the petty-cash fund and money on deposit in the bank.
- **Investment portfolio:** Investments are also usually liquid assets. Your investment portfolio includes savings accounts, short-term government bonds and other safe securities that you invest in to watch your cash earn a bit of money while you wait to use it.
- **Debtors:** *Debtors* represent the money that customers owe you for goods and services that you've already delivered. Maybe you give customers 30, 60, or 90 days to pay. You want to keep tabs on this particular asset. You may end up reducing it by some percentage if you run into deadbeat customers who just won't pay up.
- **Stock:** The cash value of your stocks can be a bit tricky to calculate, but it should reflect the costs of the raw materials and supplies that you have on hand, as well as

the value of partially finished products and products that are ready to be shipped.

- **Prepaid expenses:** If you pay any of your business expenses ahead of time, you should treat them as current assets. These expenses may include paid-up insurance premiums or retainers for unused accounting or advertising services.

Fixed assets

Fixed assets are fixed in the sense that they can't be readily converted to cash. These assets are the items that usually cost a great deal of money up front and are meant to last for several years – things like buildings, trucks, machines and computers.

In the balance sheet, the value of a fixed asset is based on its original cost minus its accumulated depreciation over time, so the figure doesn't necessarily reflect the true market value of the asset or how much it may actually cost to replace it. Fixed assets can include the following:

- **Land:** The land that your company owns is listed separately in the balance sheet, because it doesn't depreciate over time; its value on the books remains the same from year to year.
- **Buildings, equipment, machinery:** This asset represents the original cost of all the expensive items that you've invested in to operate your company. The entry should include anything you purchase that's expected to last more than a year.
- **Minus accumulated depreciation:** Depreciation measures the decline in the useful value of an expensive item over time, so the original cost of all your fixed assets (excluding any land) is reduced by an amount

equal to the total depreciation accumulated over the years. Notice that Global Gizmos shows accumulated depreciation increasing by £30,000 in its most recent year. Because its fixed assets are now worth £30,000 less on paper, Global Gizmos also takes a £30,000 depreciation expense in its profit and loss account (refer to number three in Figure 10-1).

Intangibles

Even though you can't polish any of these assets, intangibles can be extremely important to your company. *Intangibles* include such things as your rights to a manufacturing patent, a long-term contract, or an exclusive service franchise. Intangibles also cover something called goodwill. Although not at all obvious from the name, *goodwill* represents the extra money that you may spend for an asset above and beyond its fair market value – maybe because the asset is worth more to your company than to anybody else.

By definition, intangibles are hard to describe and difficult to put a real value on. Some companies don't even try. Instead, they place a nominal value of £1 on all their intangibles to indicate that although these assets exist, they've no way of measuring what the intangibles are actually worth.

Liabilities and owners' equity

Your company's *liabilities* cover all the debts and obligations that you enter into while you run your company. In the same way that assets are divided up, your liabilities are separated into categories, based on how soon they're due. *Current liabilities* are those that have to be paid off within a year; *long-term liabilities* may stay on the books much longer. When these liabilities are subtracted from total assets, you're left with *owners' equity*, which is a measure of how much the company is actually worth.

Current liabilities

Current liabilities are the debts that your company has agreed to pay in the short term (say, within a year), so you have to be able to cover them from your current assets. What's left over (the difference between your current assets and current liabilities) is so important that it has a name: *working capital,* which is the chunk of money that you actually have to work with. Here are some standard liabilities:

- **Creditors:** *Creditors* represent the amounts that you owe your regular business creditors as part of your ongoing operations. At any given time, you may have accounts payable to all sorts of outside suppliers and service people, including the merchants, professionals and even utility companies that you deal with every day.
- **Accrued expenses payable:** On any given day, your company also owes salaries and wages to its employees, interest on bank loans and maybe insurance premiums – not to mention the taxes that you haven't sent in. To the extent that any of the obligations are unpaid on the date of the balance sheet, these liabilities are totalled as *accrued expenses payable*.

Long-term liabilities

Long-term liabilities usually represent large chunks of money that you're scheduled to pay back over several years. These liabilities are often at the centre of your company's financing. You may have issued bonds or a 'Director's Loan' to investors, for example, or you may have gone directly to the bank and secured a loan against your company's assets. In any case, you're probably using the money to invest in long-term growth of the company – acquiring new equipment, building a new manufacturing facility, developing additional products, or expanding into new markets.

Owners' equity

A company's owners come in various shapes and sizes. Their investments and equity in the company are arranged and distributed in all sorts of ways and can become incredibly complicated, especially if the company is a traded public limited company (plc). But don't be confused. All this complexity boils down to two major sources of equity: money and resources that flow in from outside the company, and profits that the owners keep and pump back into the company. Owners' equity can be any of the following:

- **Share capital:** The money that's invested in your company can take various forms, from the direct infusion of cash by inside owners who manage the business to the buying and selling of shares that represent small chunks of the company owned by outside investors. Share capital represents the total of all this money, no matter where it comes from or how you describe it.

- **Retained earnings:** Your company makes a profit each year (at least, we hope it does), and you choose what to do with that excess cash. You can distribute it to the owners (that arrangement is where dividends come from) or keep part of it to reinvest in the company. If you put profits back into the company, it can grow. And if the company grows, you can increase the company's net worth and owners' equity (at least, we hope you do). *Retained earnings*, also known as reserves, represent the profits that you plough back into the company year after year.

Keep the following in mind when interpreting the balance sheet:

- A balance sheet is a snapshot of your financial condition at a particular moment – usually, the end of the year.
- Your assets include everything that has monetary value, ranging from cash and investments to buildings and stocks.
- Liabilities include all the debts and financial obligations that you incur in running your company.
- Subtract liabilities from assets to calculate your equity in the business.

Examining the Cash-Flow Statement

If you know what your company is worth and how much it makes every year, can't you just relax and assume that your financial plan is in reasonably good order? After all, what else do you need to know?

As it turns out, you've got to keep close track of one other absolutely indispensable resource: cash. No matter how good things look on paper – no matter how bright the balance sheet and how rosy the income statement – you still need cash on hand to pay the bills. The fact that you've got assets and profits doesn't automatically mean that you've money in the bank. Cash can turn out to be much more important than income, profits, assets and liabilities put together, especially in the early stages of your company.

The *cash-flow statement* monitors changes in your cash position over a set period. The top half of the statement tracks the flow of cash in and out of your company; the bottom half reports where the funds end up. Just like the balance sheet, the top and bottom halves of a cash-flow statement match. Given the importance of ready cash, you want to look at cash-flow statements on a regular basis – quarterly, monthly, or maybe even weekly.

Figure 10-3 shows a cash-flow statement for Global Gizmos Company. The cash-flow statement contains many of the same elements as a profit and loss account, but with a few critical adjustments.

Cash in and cash out

The top half of the cash-flow statement deals with the inflow and outflow of cash, tracking where your company gets funds and what you use those funds for. Cash flow is a little more honest than a profit and loss account, because the cash-flow statement shows money coming in only when you actually deposit it and money going out only when you actually write a cheque.

Figure 10-3: A cash-flow statement monitors changes in the company's cash position over time.

Cash Flow at a Glance

Global Gizmos Company

CASH FLOW AS OF DECEMBER 31		
INFLOW AND OUTFLOW	**This Year**	**Last Year**
Funds Provided By:		
Gross receipts on sales	825,000	760,000
Dividend and interest income	3,000	2,000
Share capital	5,000	10,000
Total Funds In	£ 833,000	£ 772,000
Funds Used For:		
Cost of goods produced	555,000	515,000
Sales, general, and administration	160,000	150,000
Interest expense	13,000	14,000
Taxes	20,000	18,000
Buildings, equipment, machinery	40,000	50,000
Long-term debt reduction	10,000	5,000
Dividend distribution to owners	5,000	5,000
Total Funds Out	£ 803,000	£ 757,000
NET CHANGE IN CASH POSITION	**£ 30,000**	**£ 15,000**
CHANGES BY ACCOUNT	**This Year**	**Last Year**
Changes In Liquid Assets		
Cash	15,000	5,000
Investment portfolio	15,000	10,000
Total Changes	£ 30,000	£ 15,000
NET CHANGE IN CASH POSITION	**£ 30,000**	**£ 15,000**

Funds provided by

Where does all that money originate? Because the cash-flow statement reflects the actual receipt of cash, no matter where it comes from, the entries are a bit different from the revenue shown in a company's profit and loss account. These funds are usually made up of the following:

- **Gross receipts on sales:** This entry represents the total money that you take in on sales during the period. Gross receipts are based on your gross revenue, of course, but they also take into account when you actually receive payment. Global Gizmos, for example, received all of its £810,000 in gross revenue this year, plus £15,000 in debtors that the company was owed from last year, for a total of £825,000.
- **Dividend and interest income:** Your income from savings accounts and other securities is also reported in your profit and loss account. The amounts should be the same, as long as you actually receive the money during the period covered by the cash-flow statement.
- **Share capital:** The money invested in your company shows up as part of the owners' equity in your balance sheet. Invested capital doesn't represent revenue from your business operations, of course, so it never appears in the profit and loss account, but it can be a source of cash for the company. As Figure 10-3 shows, Global Gizmos received an additional £5,000 in invested capital this year.

Funds used for

Where does all the money go? The cash-flow statement keeps track of the costs and expenses that you incur for anything and everything. Some of the expenses appear in the profit and loss account; others don't, because they don't directly relate to your costs of doing business. These funds usually consist of the following:

- **Cost of goods produced:** This entry represents the total cost of producing your product or service during the period. The cost of goods produced often differs from the cost of goods sold shown in your profit and loss account, because the cost of goods sold also includes sales out of stock (items that your company has already produced and paid for) and doesn't include the cost of products that you add to stock. Global Gizmos, for example, reduced its overall inventory by £5,000 this period, so the company's cost of goods produced was £5,000 less than its cost of goods sold from the profit and loss account.
- **Sales, general and administration (SG&A):** These expenses are the same SG&A expenses that appear in a profit and loss account, except that paying off bills that you owe or postponing payments may change the amount. Global Gizmos paid down £10,000 in both its accounts payable and expenses payable this year, increasing its SG&A cash outflow by £20,000, for a total of £160,000.
- **Interest expense:** Interest expense shows up in the profit and loss account as well. The number reflects the amount that you actually pay out during the period.
- **Taxes:** Taxes also appear in the profit and loss account. But in the cash-flow statement, taxes are the ones that you actually pay out during the period.
- **Buildings, equipment, machinery:** When your company buys an expensive item, it doesn't appear in your profit and loss account as an expense, because you're really just trading cash for another asset. Instead, you take a depreciation expense each year to reflect the spread of that cost over the asset's useful life. When you buy the building, lorry, or whatever, however, you've got to pay

for it. The cash-flow statement reflects those costs. Global Gizmos, for example, shelled out £40,000 this year for new equipment.

- **Long-term debt reduction:** It costs you money to reduce any long-term debt that your company may have, and that expense doesn't appear in the profit and loss account. Global Gizmos reduced its long-term debt by £5,000 last year and £10,000 this year.
- **Dividend distribution to owners:** The portion of your company's profits that you decide to give back to the owners comes directly out of your cash box. Again, this entry isn't a business expense in the profit and loss account, but it costs you nonetheless. Global Gizmos distributed £5,000 to its owners this year.

What's left over

The flow of cash in and out of your business is like water flowing in and out of a reservoir. If more water comes in than goes out, the water level goes up, and vice versa. When your company's cash reserves rise, however, the money flows into one or more of your liquid-asset accounts. The bottom half of your cash-flow statement keeps track of what's happening to those accounts.

Changes in liquid assets

With cash flowing in and out of the company, your liquid assets are going to change during the period covered by the cash-flow statement. The items listed in this portion of the cash-flow statement are the same ones that appear in the balance sheet. This year, for example, Global Gizmos improved its cash reserves and investment portfolio by £15,000 each.

Net change in cash position

Raising the level of your liquid-asset accounts has the happy effect of strengthening your cash position. Global Gizmos increased its liquid assets and cash position by £30,000 this year. Not coincidentally, this £30,000 is also the difference between the £833,000 that Global Gizmos took in during the year (Total Funds In) and the £803,000 that it spent (Total Funds Out).

A few things to remember about cash flow:

- A cash-flow statement tracks the movement of cash in and out of your company.
- Cash in represents money that you deposit; cash out, the cheques that you write.
- Cash flow can be more important than income, assets and profits combined, especially for a new business.

Evaluating Financial Ratios

Armed with a profit and loss account, a balance sheet and a cash-flow statement, you’ve a relatively complete financial picture of your company in front of you. But when you look everything over, what does that financial picture actually tell you? Is it good news or bad news? What things should you plan to do differently as you go forward?

Your financial picture may tell you that you pay your bills on time, keep a cash cushion and make some money. But can your company do a better job down the road? It would be nice if you could look at the picture year after year and compare it against a competitor, several competitors or even your entire industry. But companies come in all shapes and sizes, and it can be hard to compare numbers from any two companies and make sense of them.

As a result, companies use *financial ratios*. When you divide one number by another, thereby creating a ratio, you eliminate many of the problems of comparing things on different scales.

Take your personal finances as an example. You're looking for help on investments. One friend boasts that she made £5,000 on the stock market last month; another made only £1,000. Who do you ask for advice? It depends. If the first friend has £500,000 invested and the second friend has only £20,000, who's the savvy investor?

A ratio gives you the answer. The first friend saw a return of only 1 per cent (5,000 ÷ 500,000), whereas the second friend realised a better return of 5 per cent (1,000 ÷ 20,000).

Comparing two companies of different sizes works just the same way. If you want to compare your company's financial ratios with those of major competitors or with an industry average, you need to get your hands on outside data. You can always start by asking your banker, accountant or investment adviser, because financial institutions keep close track of standard ratios across industries. But you should also check out financial-data services such as Standard and Poor's, Value-Line, and Moody's. Also, Dun & Bradstreet offers a publication called *Industry Norms and Key Business Ratios*.

With all these data in hand, you can see how your company measures up, because you can bet that your investors, creditors and competitors are going to, even if you don't.

Financial ratios fall into three categories. The first two categories take your company's vital signs to see whether you're going to make it (remain solvent). One set of ratios measures the company's capability to meet its obligations in the short term; the other looks at the long term. The final set of ratios indicates just how strong and vigorous your company really is, measuring its relative profitability from several points of view.

Short-term obligations

The overriding importance of being able to pay your bills every month is the major reason why current assets and current liabilities are separated in the company's balance sheet. The difference between the two – your working capital – represents a safety net that protects you from almost certain financial catastrophe.

How much working capital do you need to ensure survival? Having the liquid assets available when you absolutely need them to meet short-term obligations is called *liquidity*. You can use several financial ratios to test your company's liquidity. You can monitor the following ratios year by year and measure them against your competitors' ratios and the industry averages.

Current ratio = current assets ÷ current liabilities

You determine your company's current ratio by looking at the balance sheet and dividing total current assets by total current liabilities. Global Gizmos Company, for example, has a current ratio of £320,000 ÷ £140,000, or 2.3 (refer to Figure 10-2). You can also express this ratio as 2.3 to 1 or 2.3:1.

Like most financial ratios, the current ratio isn't an especially precise measurement, so don't bother calculating it to more than one or two decimal places.

What's the magic number to aim for? If your company falls below a current ratio of 1.0, you're in serious financial danger. In most cases, you want the number to stay above 2.0, meaning that you've more than twice the current assets that you need to cover current liabilities. But again, the answer depends on your industry. Companies that move stocks quickly can often operate with somewhat lower current ratios, because the stocks themselves are a little more liquid. You don't want your current ratio to get too high, either. Then you could be sitting on excess cash that should really be put to work and invested back in the company.

Quick ratio = (cash + investments + debtors) ÷ current liabilities

Sometimes, the quick ratio is called the *acid test,* because this ratio is more stringent than the current ratio. The quick ratio doesn't allow you to count stock and prepaid expenses as part of your current assets, because it can sometimes be hard to turn them back into cash quickly, especially in an emergency. This situation is particularly true in industries in which products go out of fashion rapidly or are quickly outdated by new technology.

Global Gizmos has a quick ratio of £200,000 ÷ £140,000, or 1.4, this year (refer to Figure 10-2). You want to keep your own company's quick ratio above 1.0 by a comfortable margin that is in line with your industry.

Stock turnover = cost of goods sold ÷ stock

Stock turnover tells you something about how liquid your stocks really are. This ratio divides the cost of goods sold, as shown in your yearly profit and loss account, by the average value of your stock. If you don't know the average, you can estimate it by using the stock figure as listed in the balance sheet at the end of the year.

Global Gizmos has a stock turnover of £560,000 ÷ £115,000, or 4.9. (Refer to Figures 10-1 and 10-2 for the company's profit and loss account and balance sheet, respectively.) This ratio means that Global Gizmos turns over its stocks almost five times each year. Expressed in days, Global Gizmos carries a 75-day (365 ÷ 4.9) supply of stock.

Is a 75-day inventory good or bad? It depends on the industry and even on the time of year. A car dealer who has a 75-day supply of cars at the height of the season may be in a strong stock position, but the same stock position at the end of the season may be a real weakness. As automation, computers and information systems make business operations more efficient across all industries, stock turnover is on the rise, and the average number of days that stock of any kind hangs around continues to shrink.

Debtor turnover = sales on credit ÷ debtors

Debtor turnover tells you something about liquidity by dividing the sales that you make on credit by the average debtors. If an average isn't available, you can use the debtors from a balance sheet.

If Global Gizmos makes 80 per cent of its sales on credit, its debtor turnover is (£810,000 x 0.8) ÷ £135,000, or 4.8. (Refer to Figures 10-1 and 10-2 for Global Gizmos' profit and loss account and balance sheet.) In other words, the company turns over its debtors 4.8 times per year, or once every 76 days, on average. That's not so good if Global Gizmos' payment terms are 30 or 60 days. Unlike fine wine, debtors don't improve with age.

Long-term responsibilities

Your company's liquidity keeps you solvent from day to day and month to month, but what about your ability to pay back long-term debt year after year? Two financial ratios indicate what kind of shape you're in over the long haul. The first ratio gauges how easy it is for your company to continue making interest payments on the debt; the second tries to determine whether the principal amount of your debt is in any danger.

If you've read this chapter from the beginning, you may be getting really bored with financial ratios by now, but your lenders – bankers and bondholders, if you have them – find these long-term ratios to be incredibly fascinating, for obvious reasons.

Times interest earned = earnings before interest and taxes ÷ interest expense

Don’t get confused – earnings before any interest expense and taxes are paid (EBIT) really is just the profit that you have available to make those interest payments in the first place. Global Gizmos, for example, has an EBIT of $57,000 and an interest expense of $13,000 this year for a times-interest-earned ratio of 4.4. (Refer to Figure 10-1 for the company’s income statement.) In other words, Global Gizmos can meet its interest expense 4.4 times over.

You may also hear the same number called an *interest coverage*. Lenders get mighty nervous if this ratio ever gets anywhere close to 1.0, because at that point, every last penny of profits goes for interest payments on the long-term debt.

Debt-to-equity ratio = long-term liabilities ÷ owners’ equity

The debt-to-equity ratio says a great deal about the general financial structure of your company. After all, you can raise money to support your company in only two ways: borrow it and promise to pay it back with interest, or sell pieces of the company and promise to share all the rewards of ownership. The first method is debt; the second, equity.

Global Gizmos has a debt-to-equity ratio of $90,000 ÷ $385,000, or .23 per cent. (Refer to Figure 10-2 for Global Gizmos’ balance sheet.) This ratio means that the company has more than four times as much equity financing as it does long-term debt.

Lenders love to see lots of equity supporting a company’s debt, because they know that the money they loan out is safer. If something goes wrong with the company, they can go after the owners' money. Equity investors, on the other hand, actually want to take on some risk. They like to see relatively high debt-to-equity ratios, because that situation increases their leverage and (as the following section points out) can substantially boost their profits. So the debt-to-equity ratio that's just right for your company depends not only on your industry and how stable it is, but also on who you ask.

Relative profitability

If profit is the bottom line for your business, profitability is the finishing line. Profitability tells you how well you measure up when it comes to creating financial value out of your company. Profitability ratios allow you to keep track of your own performance year by year. They also allow you to compare that performance against that of other competitors, other industries and even other ways of investing resources.

You can easily invest the money that flows into your company in other businesses, for example, or in bank accounts, property or government bonds. Each of these investments involves a certain level of risk. By comparing profitability ratios, you begin to see whether your own company measures up, generating the kinds of financial rewards that justify the risks involved.

Profitability ratios come in three flavours. The first type of ratio examines profit relative to your company sales. The second type examines profit relative to total assets. The final type examines profit relative to owners' equity. Each of the ratios reflects how attractive your company is to an investor.

Net profit margin = net profit ÷ gross revenue on sales

The net profit margin is your net profit divided by your gross revenue. The ratio really says more about your costs in relation to the prices that you charge, however. If your net profit margin is low compared with that of other companies in your industry, your prices are generally lower or your costs are too high. Lower margins are quite acceptable if they lead to greater sales, larger market share and bigger profits down the road, but you want to monitor the ratio carefully. On the other hand, no one's going to quibble with net profit margins that are on the high side, although they're an awfully good way to attract new competitors.

Global Gizmos Company has a net profit margin of £50,000 ÷ £810,000, or 6.2 per cent, this year. (To examine Global Gizmos' profit and loss account, refer to Figure 10-1.) That result is a substantial increase from the 4.6 per cent for the year before. The company didn't grow just in terms of revenue, but also became more profitable.

When you calculate your own net profit margin, you should also think about calculating margins based on your operating profit and gross profit. Together, these ratios give you a better idea of where your company's profitability really comes from.

Return on investment = net profit ÷ total assets

JARGON ALERT

Net profit divided by total assets gives you the overall return that you're able to make on your company's assets – referred to as *return on assets* (ROA). Because these assets are equal to all your debt and equity combined, the ratio also measures an average return on the total investment in your company. What does the ratio mean? It's similar to the yield on Grandma's savings bonds or the return on that hot new mutual fund that you've discovered. *Return on investment* (ROI) is widely used as a test of company profitability, because you can compare it to other types of investments that an investor can put money into.

Watch out for one thing, though: the value of the total assets used in the calculation of ROI usually is taken from a company's balance sheet and can be misleading. If the assets have been around for a while, the numbers on the page may not reflect real replacement costs, and if the assets are undervalued, the ROI is bound to be a bit exaggerated.

Global Gizmos has an ROI of £50,000 ÷ £ 475,000, or 10.5 per cent, this year. (Refer to Figures 10-1 and 10-2 for the company's profit and loss account and balance sheet.) That figure is up from 7.1 per cent the year before, and the increase certainly is good news.

Whether your own company's ROI is where it should be depends to a large extent on your industry, as well as on what the economy is doing at the moment.

Return on equity = net profit ÷ owners' equity

Net profit divided by the owners' equity in your company gives you the return on just the equity portion of the investment (ROE). Keep in mind that you've already taken care of all your bankers and bondholders first by paying their return – the interest expense on your debt – out of your profits. Whatever is left over goes to the owners and represents their return on equity.

Your creditors always get paid first, and they get paid a fixed amount; everything else goes to the owners. That's where *leverage* comes in. The more you finance your company by using debt, the more leveraged you are, and the more leveraged you are, the more you're using other people's money to make money. Leverage works beautifully as long as you're good at putting that money to work – creating returns that are higher than your interest costs. Otherwise, those other people may end up owning your company.

Global Gizmos, for example, has an ROE of £50,000 ÷ £385,000, or 13.0 per cent. (The profit and loss account and balance sheet shown in Figures 10-1 and 10-2, earlier in this chapter, shed light on where these figures come from.) Without any leverage, that ROE would be the same as the company's ROI, or only 10.5 per cent. More leverage probably would raise the ROE even higher, upping the risk at the same time. In short, leverage makes the good years better for the owners and the bad years much worse.

REMEMBER

Don't forget these points about ratios:

- Financial ratios allow you to compare your performance with that of other companies, especially your competitors.
- One set of ratios examines your company's vital signs to see whether your company is going to remain solvent.
- Another set of ratios examines your company's financial health by measuring profit in terms of sales, assets and equity.

Understanding Break-Even

At the start of this chapter, when costs were introduced, we implied that all were broadly similar, in that they were expenses to deduct from sales income in order to arrive at a figure for the profit being made. However, you need to grasp that two fundamentally different types of cost exist. *Fixed costs* are those that don't vary with the volume of output. So the rent on a retail outlet, for example, remains 'fixed' irrespective of the amount of sales actually achieved. Of course the cost itself is not necessarily fixed, as the landlord may change the rent. *Variable costs* are those that do change with sales levels. So a retailer needs to buy in stock to meet rising demand, and a manufacturer needs more raw materials and more workers' hours.

The break-even equation is:

> Break-even point (in units) = Fixed costs ÷ (Selling price – Unit variable cost)

So if the fixed costs were £10,000, the selling price was £5 and the cost of buying in the only product we sell is £3, then the break-even point is 5,000 units. If your goal was to make £10,000 profit, then by adding that to the fixed costs you can see that sales then need to reach 10,000 units.

A number of online spreadsheets and tutorials can take you through the process. biz/ed (www.bized.co.uk) hass a simulation that lets you see the effect of changing variables on a fairly complex breakeven calculation. Score (www.score.org/template_gallery.html) provides a breakeven analysis template and BizPep (www.bizpeponline.com/PricingBreakeven.html) sell a software program that calculates your break-even for prices plus or minus 50 per cent of your proposed selling price. You can tweak costs to see how to optimise your selling price and so hit your profit goal.

Margin of safety is the term bandied around by accountants to describe a business's capacity for making profit. For example, a business's production line is able to produce 7,000 units, and no more. If these units were all sold at £5 each, the maximum sales revenue would be £35,000. The break-even level is calculated as being when 5,000 units are sold at £5 each, generating £25,000. So the business's capacity for making profit is the 2,000 units the factory can make over and above the 5,000 required to break-even. This is usually expressed as a percentage – 2,000 ÷ 7,000 x 100 = 29 per cent. A low percentage, below 25 and 30 per cent, say, means that a business must sell a high proportion of its capacity in order to break even and vice versa. The higher the margin of safety the sooner break-even can be reached and the greater the potential to make more profit.

Chapter 11

Forecasting and Budgeting

In This Chapter

- Constructing your financial forecast
- Putting together the pro-forma balance sheet and profit and loss account
- Projecting your cash flow
- Testing your budget projections
- Estimating a balance sheet
- Preparing your long-term capital budget

How many times have you sat around the table with your family (or maybe just your dog) and talked about the importance of putting the household on a budget? Everybody knows what a budget is, of course: a way of figuring out how much you're going to spend on essentials (the things that you need) and incidentals (all the frills). By its very nature, a budget is something that looks ahead, combining a forecast and a set of guidelines for spending money.

As you probably know from experience, you find it a lot easier to put together a budget if you've basic financial information to work with. It's nice to know how much money's going to come in, for example, and when you expect it to arrive. You also need to keep track of the expenses that absolutely have to be taken care of, such as the mortgage and the car payment. Only then can you begin to get a handle on what you've left over, which is called your *working capital*.

For your company, this kind of basic financial information resides in its financial statements. (For more information on financial statements, refer to Chapter 10.) These financial statements – profit and loss accounts, balance sheets, cash flow – are fairly straightforward, because they're based on how your company performed last year or the year before. Unfortunately, financial information is not quite as easy to put together and use when you have to plan for next year, three years from now, or even five years from now.

Why go to all the trouble of putting financial information together in the first place? The answer is simple. Although the numbers and financials aren't your business plan by themselves, they help you to fulfil your business plan. Without them, you're in real danger of allowing your financial condition – money (or the lack of it) – to take control of, or even replace, your business plan.

In this chapter, we help you construct a financial forecast for your company, including a pro-forma profit and loss account, an estimated balance sheet and a projected cash-flow statement. Because nothing in the future is certain, we also introduce scenario planning and what-if analysis as ways to consider several financial alternatives. Finally, we talk about how you can use the financial information to create a budget, explaining what goes into a budget and how to go about making one.

Constructing a Financial Forecast

Every philosopher-wannabe has spoken profound words about the future and about whether we should try to predict it. But we can't avoid the future. The future is there, it's uncertain, and we're going to spend the rest of our lives in it.

All of us make decisions every day based on our own personal view of what's ahead. Although things often end up surprising us, our assumptions about the future at least give us a basic framework to plan our lives around. Our expectations, no matter how far off the mark they are, encourage us to set objectives, to move forward and to achieve our goals somewhere down the road.

You can think about the future of your company in much the same way. Assumptions about your own industry and marketplace – that you'll have no new competitors, that a new technology will catch on, or that customers remain loyal, for example – provide a framework to plan around. Your expectations of what lies ahead influence your business objectives and the long-term goals that you set for your company.

AHEAD OF THE PACK

You want to be clear about what your business assumptions are and where they come from, because your assumptions are as important as the numbers themselves when it comes to making a prediction. If you're convinced that no new competitors will enter the market, say why. If you see a period of rapid technological change ahead, explain your reasons. Don't try to hide your business assumptions in a footnote somewhere; place them in a prominent position. That way, you make your financial forecast as honest, adaptable and useful as it can be. If all your assumptions are out in the open, nobody can possibly miss them and:

- Everybody who looks at your forecast knows exactly what's behind it.

- You know exactly where to go when your assumptions need to be changed.

As you may have guessed, coming up with predictions that you really believe in isn't always easy. You may trust some of the numbers (next year's sales figures) more than you do others (the size of a brand-new market). Some of your financial predictions are based on your best estimate. You may arrive at others by using sophisticated number-crunching techniques. When you get the hang of it, though, you begin to see what a broad and powerful planning tool a financial forecast can be. You find yourself turning to it to help answer all sorts of important questions, such as the following:

- What cash demands does your company face in the coming year?
- Can your company cover its debt obligations over the next three years?
- Does your company plan to make a profit next year?
- Is your company meeting its overall financial objectives?
- Do investors find your company to be an attractive business proposition?

With so many important questions at stake, a financial forecast is worth all the time and effort that you can spend on it. Because if you're not careful, a forecast can turn out to be way off base. Did you ever hear the old computer programmer's expression 'Rubbish in, rubbish out'? The same is true of financial forecasts. Your financial forecast is only as good as the numbers that go into it. If the numbers are off the mark, the reason is usually one of the following:

- Expectations were unrealistic.

- Assumptions weren’t objective.
- Predictions weren’t checked and rechecked.

The following sections examine the financial statements that make up a financial forecast. After we explain how to put these statements together, we point out which of the numbers are most important and which are the most sensitive to changes in your assumptions and expectations about the future.

Pondering the pro-forma profit and loss account

Pro forma refers to something that you describe or estimate in advance. (It can also mean something that is merely a formality and can be ignored – but don’t get your hopes up; we’re talking about a serious part of a business plan.) When you construct your financial forecast, you should try to include *pro-forma profit and loss accounts* – documents that show where you plan to get your money and how you’ll spend it – for at least three years and for as long as five years in the future, depending on the nature of your business. You should subdivide the first two years into quarterly profit projections. After two years, when your profit projections are much less certain, annual projections are fine. (For a look at a profit and loss account, flip to Chapter 10.)

Your company's pro-forma profit and loss accounts predict what sort of profit you expect to make in the future by asking you to project your total business revenue and then to subtract all your anticipated costs. The following should help you get ready:

- If you're already in business and have a financial history to work with, get all your past financial statements out right away. You can use them to help you figure out what's likely to happen next.
- If you've a new company on your hands and don't have a history to fall back on, you have to find other ways to get the information that you need. Talk to people in similar businesses, sit down with your banker and your accountant, visit a trade association and read industry magazines and newspapers.

The pro-forma profit and loss account has two parts – projected revenue and anticipated costs.

Projected revenue

Your company's projected revenue is based primarily on your sales forecast – exactly how much of your product or service you plan to sell. You have to think about two things: how much you expect to sell, naturally, and how much you're going to charge. Unfortunately, you can't completely separate the two things, because any change in price usually affects the level of your sales.

Your sales forecast is likely to be the single most important business prediction that you ever make. If you get it wrong, the error can lead to mountains of unsold stock or a sea of unhappy, dissatisfied customers – a financial disaster in the making. A souvenir T-shirt company that *over*estimates how many Cup Final T-shirts customers are going to buy, for example, is going to be left with an awful lot of worthless merchandise. By the same token, the corner toy shop that *under*estimates how many kids will want the latest Bratz will have to answer to many frustrated parents and unhappy children – and suffer lost sales.

How do you get the sales forecast right? Start by looking at its formula:

Sales forecast = Market size x Growth rate x Market-share target

Check out these points:

- Market size estimates the current number of potential customers.
- Growth rate estimates how fast the market will grow.
- Market-share target estimates the percentage of the market that you plan to capture.

Because your sales forecast has such a tremendous impact on the rest of your financial forecast – not to mention on the company itself – you should try to support the estimates that you make with as much hard data as you can get your hands on. Depending on your situation, you can also rely on the following guides:

- **Company experience:** If you already have experience and a track record in the market, you can use your own sales history to make a sales prediction. But remember that your sales are a combination of the size of the market and your own share of the market. You may still need other sources of data (listed in the following paragraphs) to help you estimate how the market and your share of it are likely to change in the future.

Using data from outside your company also ensures that you're taking full advantage of all the growth opportunities that are available. All too often, companies use last year's sales as a shortcut to estimating next year's sales, without taking the time to look at how their markets are changing. Because a sales forecast can be self-fulfilling, those companies may never know what they missed!

- **Industry data:** Industry data on market size and estimates of future growth come from all quarters, including trade associations, investment companies and market-research firms (covered more extensively in Chapter 4). You can also get practical and timely information from industry suppliers and distributors.
- **Outside trends:** In certain markets, sales levels are closely tied to trends in other markets, social trends, or economic trends (a phenomenon described in Chapter 12). Car sales, for example, tend to move with the general economy. So when car dealers track what's happening with the Gross Domestic Product (GDP), they get an estimate of where car sales are headed.

Even if a product is brand-new, you can sometimes find a substitute market to track as a reference. When frozen yogurt first appeared on the scene, for example, frozen-yogurt makers turned to the sales history of ice cream to help support their own sales forecasts.

Speaking of ice cream, don't forget to factor sales cycles into your forecast; in most of the UK, ice cream sales freeze over in January and February. Other markets may have other cycles.

Next, multiply your sales forecast by the average price that you expect to charge. The result is your projected revenue and it looks like this:

Projected revenue = Sales forecast x Average price

Where does the average price come from? Your average price is based on what you think your customers are willing to pay and what your competitors are charging. Use the information that you pack away on your industry and the marketplace. (Refer to Part II for how to analyse your industry and customers.) The price should also take into account your own costs and your company's overall financial situation.

Now put all the numbers together and see how they work. A company called Global Gizmos serves as an example. Sally Smart, widgets product manager, is putting together a three-year revenue projection. Using industry and market data along with the company's own sales history, Sally estimates that the entire market for widgets will grow about 10 per cent a year and that Global Gizmos' market share will increase by roughly 2 per cent a year, with projected price increases of approximately £1 to £2. She puts the numbers together in a table so that she can easily refer to the underlying estimates and the assumptions that support them (see Table 11-1).

Table 11-1 Widget Revenue Projection for Global Gizmos Company

Revenue projection	*Year 1*	*Year 2*	*Year 3*
Projected market size (units)	210,000	231,000	254,100
Projected market share (per cent)	20	22	24
Sales forecast (units)	42,000	50,820	60,980
Average price	£26	£27	£29
Projected revenue	£1,092,000	£1,372,140	£1,768,420

Anticipated costs

When you complete your revenue projection, you're still not quite finished. You still have to look at anticipated costs – the price tag of doing business over the next several years. To make life a little easier, you can break anticipated costs down into the major categories that appear in a pro-forma profit and loss account: projected cost of goods sold, projected sales, general and administration expenses, projected interest expenses and projected taxes and depreciation. The following list defines these categories:

- ***Projected cost of goods sold (COGS):*** COGS, which combines all the direct costs associated with putting together your product or delivering your service, is likely to be your single largest expense. If you've a track record in the industry, you've a useful starting point for estimating your company's future COGS.

  Even though the following formula may look ugly, it's actually a simple way to calculate your projected COGS. Based on the assumption that the ratio of your costs to your revenue will stay the same:

Projected COGS = (Current COGS ÷ Current revenue on sales) × Projected revenue

If you haven't been in business long or if you're just starting a company, you won't have access to this kind of information. But you can still estimate your projected COGS by substituting industry averages or by using data that you find on other companies that have similar products or services.

WARNING! Although this ratio approach has the advantage of being simple, you can get into trouble if you don't confirm the COGS that you come up with. At the very least, you should sum up the estimates of the major costs looming ahead (materials, labour, utilities, facilities and so on) to make sure that the projected COGS makes sense. This method is tougher, but it gives you a chance to make separate assumptions and projections for each of the underlying costs. You may be pleasantly surprised; you may discover that as your company gets bigger and you're in business longer, your projected revenue goes up faster than your costs do. The effect is called the experience curve (explained thoroughly in Chapter 13), and it means that your COGS-to-revenue ratio will actually get smaller in the coming years.

- **Sales, general and administration (SG&A):** SG&A represents your company's overheads: sales expenses, advertising, travel, accounting, telephones and all the other costs associated with supporting your business. If your company is brand-new, try to get a feel for what your support costs may be by asking people in similar businesses, cornering your accountant, or checking with a trade association for average support costs in your industry. Also come up with ballpark numbers of your own, including estimates for all the major overhead expenses that you can think of.

If you've been in business for a while, you can estimate a range for your SG&A expenses using two calculations. The first method projects a constant spending level, even if your company's sales are growing. In effect, you assume that your support activities all get more efficient and accommodate your additional growth without getting bigger themselves. The other method projects a constant SG&A-to-revenue ratio. In this case, you assume that support costs grow as fast as your revenue and that you won't see any increase in efficiency. An accurate SG&A forecast probably lies somewhere in between. Given what you know about your company's operations, come up with your own estimate and include the assumptions that you make.

- **Interest expense:** Your interest expense is largely the result of decisions that you make about your company's long-term financing. Those decisions, in turn, are influenced by your ability to pay your interest costs out of profits. Think about what sort of financing you will need and what interest rates you may be able to lock in, then estimate your interest expense as best you can.

- **Taxes and depreciation:** Taxes certainly affect your bottom line, and you want to include your projections and assumptions in your anticipated costs. You can usually estimate their general impact in the future quite easily by looking at their impact on your company now. If you're starting a new business, do a bit of research on tax rates.

  Depreciation, on the other hand, is an accountant's way of accounting for the value that your asset purchases lose over the time in which you're going to be using them. As such, depreciation is an expense that doesn't really come out of your pocket every year. You can estimate the numbers, but don't get too carried away. In the future, your depreciation expense will include a portion of those expensive items that you have to buy to keep the business healthy and growing (computers, cars, forklifts and so on).

When you plug the numbers into your pro-forma profit and loss account and calculate your net profit, be prepared for a shock. You may discover that the profit you were expecting in the first year or two has turned into a projected loss. But don't panic. New business ventures often lose money for some time, until their products catch on and some of the startup costs begin to get paid off. Whatever you do, don't try to turn a projected loss into a profit by fiddling with the numbers. The point isn't to make money on paper; the point is to use the pro-forma profit and loss account as a tool that can tell you what sort of resources and reserves you need to survive until losses turn into predicted profits.

Even if your projection shows a healthy profit, ensure that you also complete a Cash Flow Projection (see Chapter 10) to make sure you can afford to trade at the projected level. Making a profit does not always mean that you have *cash* on hand to buy raw materials, pay staff and pay taxes.

Looking at the estimated balance sheet

Another part of your financial forecast is the *estimated balance sheet,* which, like a regular balance sheet, is a snapshot of what your company looks like at a particular moment – what it owns, what it owes and what it's worth.

Over the years, these snapshots (estimated balance sheets) fill a photo album of sorts, recording how your company changes over time. Your estimated balance sheets describe what you want your company to become and how you plan to get it there. The estimated balance sheets that you put together as part of your financial forecast should start with the present and extend out three to five years in a series of year-end projections. (For much more information on balance sheets, check out Chapter 10.)

While the pro-forma profit and loss accounts in your financial forecast project future revenue, costs and profits, your estimated balance sheets lay out exactly how your company will grow so that it can meet those projections. First, you want to look at what sorts of things (*assets*) you need to support the planned size and scale of your business. Then you have to make decisions about how you're going to pay for those assets. You have to consider how you're going to finance your company – how much debt you plan to take on (*liabilities*) and how much of the company's own money (*equity*) you plan to use.

Assets

Your company's projected assets at the end of each year include everything from the money that you expect to have in the petty-cash drawer to the buildings and machines that you plan to own. Some of these assets will be current assets, meaning that you can easily turn them into cash; others will be fixed assets. Don't be confused by the word *current;* we're still talking about the future. Check out the following definitions of types of asset:

- **Current assets:** The cash on hand and your investment portfolio, as well as debtors and stocks, add up to your current assets. How much should you plan for? That depends on the list of current liabilities (debts) you expect to have, for one thing, because you have to pay short-term debts out of your current assets. What's left over is your working capital. The amount of working capital that you need depends on your future cash-flow situation.

  Your estimates of future debtors (money that customers will owe you) depend on the payment terms that you offer and on the sales that you expect to make on credit.

  Projected stocks (the amount of stuff in your warehouse) depend on how fast your company can put together products or services and get them to customers. The longer it takes to build products, the bigger the stock cushion you may need.

- **Fixed assets:** Land, buildings, equipment, machinery and all the other things that aren't easy to dispose of make up your company's fixed assets. Your estimated balance sheets should account for the expensive items that you expect to purchase or get rid of. Your capital purchases (such as additional buildings, more equipment and newer machines) can play a major role in company growth, increasing both your revenue and the scale of your business operations.

Keep an eye on how each machine or piece of equipment helps your bottom line. If you plan to buy something big, make a quick calculation of its *payback period* (how long it's going to take to pay back the initial cost of the equipment out of the extra profit that you make). Is the payback period going to be months, years, or decades? As you plan for the future, you also want to keep track of your overall expected *return on assets* (ROA), which is your net profits divided by your total assets. This figure monitors how well you expect all your assets to perform in the future. Compare your estimated ROA with industry averages and even with other types of investments.

Extruding better returns

A small, up-and-coming West Country company (we'll call it Klever Kitchens) has made a big name for itself in the kitchen-accessories business. Klever Kitchens produces all sorts of newfangled gadgets and utensils for the gourmet chef – everything from pasta hooks to melon scoops. Because many of the company's products are made of plastic, the owners face a decision about the purchase of a second plastic-extruding machine. They know that the investment is sound, because the new £20,000 machine will allow the company to grow, and they expect it to generate an additional £4,000 a year in profit, resulting in an estimated payback period of about five years (£20,000 divided by £4,000). The question is whether to pay for the extruder by borrowing the funds or by using some of the company's equity reserves.

The owners understand that using debt is a way to leverage the company. The bank has already agreed to loan Klever Kitchens 75 per cent of the £20,000 investment at a fixed 8 per cent interest rate. But what do the numbers say?

Return on equity (ROE) really measures how much money Klever Kitchens makes on the money that it invests (ROE = (Added profit – Interest expense) ÷ Equity). By taking on debt, the owners expect to earn an additional £2,800 on their investment of £5,000 in the new extruder, for an ROE of 56 per cent. That figure is almost three times the return that they would receive by putting up the funds themselves.

Acting like a financial crowbar, leverage allows Klever Kitchens to use other people's money to generate profits for itself. The risks are also a bit higher, of course, because the owners have to make added interest payments or face losing the extruder and maybe the entire company. In this case, Klever Kitchens should borrow the funds, deciding that the rewards are well worth the risks.

Additional Plastic Extruder	No Leverage	Leverage
Liability	£0	£15,000
Equity	£20,000	£5,000
Added net profit	£4,000	£4,000
Added interest expense	£0	£1,200
Added profit minus interest expense	£4,000	£2,800
Return on equity (ROE)	20%	56%

Liabilities and owners' equity

Estimated balance sheets have to balance, of course, and your projected assets at the end of each future year have to be offset by all the liabilities that you intend to take on, plus your projected equity in the company. Think about how *leveraged* you intend to be (how much of your total assets you expect to pay for out of money that you borrow). Your use of leverage in the future says a great deal about your company. It shows how confident you are about future profits; it also says, loud and clear, how willing you are to take risks for future gain. For more about how leverage works, check out the sidebar 'Extruding better returns', or flip to Chapter 10. Check out the following definitions of liabilities and equity:

- **Current liabilities:** This category consists of all the money that you expect to owe on a short-term basis. That's why these debts are called *current liabilities,* although we're still talking about the future. Current liabilities include the amounts that you expect to owe other companies as part of your planned business operations, as well as payments that you expect to send to the tax people. You have to plan your future current assets so that they not only cover these estimated liabilities, but also leave you extra capital to work with.

- **Long-term liabilities:** The long-term debt that you plan to take on represents the piece of your company that you intend to finance. Don't be surprised, however, if potential creditors put a strict limit on how much they will loan you, especially if you're just starting out. You can't easily buy a house without a down payment, and you can hardly ever start a company without one. The down payment is your equity contribution. In general, bankers and other lenders alike want to see enough equity put into your business to make them feel that you're all in the same boat, risk-wise. Equity reassures them that you and other equity investors have a real financial stake in the company, as well as tangible reasons to make it succeed.

  How much are lenders willing to loan you, and how much of a down payment do you need to come up with to satisfy them? The answer depends on several things. If you're already in business, the answer depends on how much debt your company already has, how long your company's been around, how you've done up to now and what the prospects are in your industry. If your company is new, financing depends on your track record in other businesses or on how well you do your homework and put together a convincing business plan.

Before you take on a new loan, find out what kind of debt-to-equity ratios similar companies have. (For help, turn to Chapter 10.) Make sure that yours falls somewhere in the same range. As an additional test, run some numbers to make sure that you can afford the debt and the interest payments that come along with it.

- **Owners' equity:** The pieces of your company that you, your friends, relatives, acquaintances and often total strangers lay claim to are all lumped together as *owners' equity*. Although the details of ownership can become ridiculously complex, the result of the process is fairly straightforward. All owners own part of your company, and everybody sinks or swims, depending on how well the company does.

In general, you can estimate how well the company is likely to do for its owners by projecting the return that you expect to make on the owners' investment (refer to Chapter 10 for the details). Then you can compare that return with what investors in other companies, or even other industries, are earning.

In the initial stages of your company, equity capital is likely to come from the owners themselves, either as cash straight out of the wallet or from the sale of shares to other investors. The equity at this stage is crucial, because if you want to borrow money later, you're going to have to show your bankers that you've enough invested in your business to make your company a sound financial risk. When the company is up and running, of course, you can take some of your profits and (rather than buy the little sports car that you've always wanted) give them back to the company, creating additional equity.

Unfortunately, profit has another side, and the down side is definitely in the red. Although you probably don't want to think about it, your company may lose money some years (especially during the early years). Losses don't generate equity; on the contrary, they eat equity up. So you have to plan to have enough equity available to cover any anticipated losses that you project in your pro-forma profit and loss accounts (refer to the section 'Pro-forma profit and loss account' earlier in this chapter).

Projecting cash flow

The flow of cash through a business is much like the flow of oil through an engine; it supports and sustains everything that you do and keeps the various parts of your company functioning smoothly. We all know what happens when a car's oil runs dry: the car belches blue smoke and dies. Running out of cash can be just as catastrophic for your company. If you survive the experience, it may take months or even years for your company to recover.

Cash-flow statements keep track of the cash that comes in and the cash that goes out of your company, 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've a load of bills left to pay.

Cash-flow statements should project three to five years into the future, and for the first two years, they should include monthly cash-flow estimates. Monthly estimates are particularly important if your company is subject to seasonal cycles or to big swings in sales or expenses. (If you're not sure what a cash-flow statement looks like and how this statement is different from a profit and loss account, flip to Chapter 10.)

You get a bonus from all this work: the effort that you put into creating cash-flow statements for the company gives you a head start when the time comes to create a budget for your business (see 'Making a Budget' later in this chapter).

Sounds like a summary is in order:

- Your financial forecast should include a pro-forma profit and loss account, an estimated balance sheet and a projected cash-flow statement.
- The business assumptions behind your forecast are as important as the numbers themselves.
- Your company's pro-forma profit and loss account predicts the profit that you expect to make in future years.
- Your estimated balance sheet lays out how you expect your company to grow in the future.
- Your company's projected cash-flow statement tracks your expected cash position in coming years.

Exploring Alternatives

Wouldn't it be nice if you could lay out a financial forecast – create your pro-forma profit and loss accounts, estimated balance sheets and projected cash-flow statements – and then just be done with it? Unfortunately the uncertain future that makes your financial forecast necessary in the first place is unpredictable enough to require constant attention. To keep up, you have to do the following things:

- Monitor your financial situation and revise the parts of your forecast that change when circumstances – and your own financial objectives – shift.
- Update the entire financial forecast regularly, keeping track of when past predictions were on target or off, and extending your projections another month, quarter or year.
- Consider financial assumptions that are more optimistic and more pessimistic than your own best predictions, paying special attention to the estimates that you're the least certain about.

AHEAD OF THE PACK

Why take the time to look at different financial assumptions? For one thing, they show you just how far off your forecast can be if things happen to turn out a bit differently than you expect. Also, the differences that you come up with are an important reminder that your forecasts are only that. You have to be prepared for alternatives.

Using the DuPont formula

If you really want to get a feel for what's going to happen when you change any of the estimates that make up your company's financial forecast, you have to understand a little bit about how the numbers relate to one other. The DuPont company came up with a formula that turned out to be so useful that other companies have been using a similar one ever since.

The idea behind the *DuPont formula* is simple. The recipe describes all the ingredients that play a role in determining your return on equity (ROE) – a number that captures the overall profitability of your company. ROE is your company's overall net profit divided by the owners' equity. But knowing that your ROE is 13 per cent, for example, is a lot like getting B+ on a test. You think that you did relatively well, but why did you get that particular mark? Why didn't you get an A? You want to know what's behind the mark so that you can do better next time.

By finding out what's behind your company's ROE, you've a way to measure the impact of your financial predictions on your profitability. The DuPont chart shown in Figure 11-1 turns the formula into a pyramid, with the ROE at the top. Each level of the pyramid breaks the ratio into more basic financial ingredients.

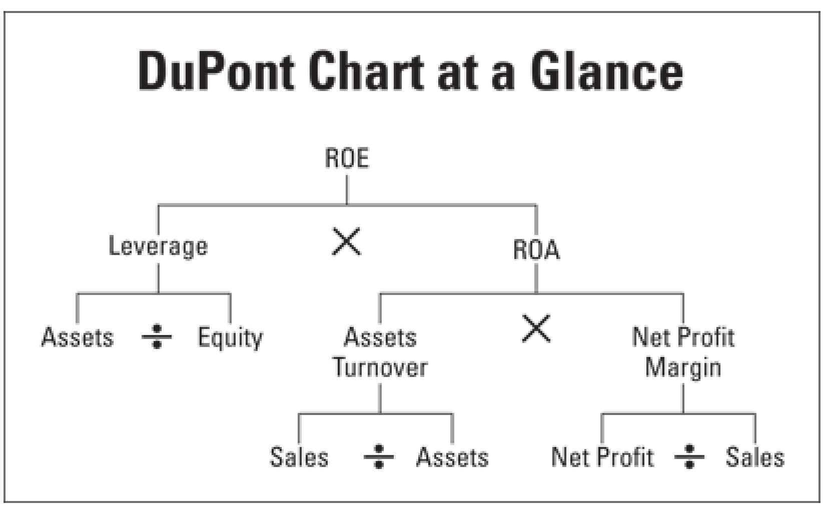


Figure 11-1: The DuPont chart turns the DuPont formula into a pyramid, with return on equity (ROE) at the top.

First level

ROE = ROA x Leverage

You can increase your company's return on equity by increasing the overall return on your company assets or by increasing your leverage (the ratio of your total company assets to equity).

Second level

Leverage = Assets ÷ Equity

As your debt increases relative to equity, so does your company's leverage.

ROA = Asset turnover x Net profit margin

You can increase your return on company assets by turning those assets into more sales or by increasing the amount of money that you make on each sale.

Third level

Asset turnover = Sales ÷ Assets

Asset turnover is the amount of money that you take in on sales relative to your company's assets. The bigger your asset turnover, the more efficient you are at turning assets into sales.

Net profit margin = Net profit ÷ Sales

Net profit margin is the profit that you make after subtracting expenses divided by the amount of money you take in on sales. The larger your profit margin, the lower your overall costs relative to the prices that you charge.

Exploring the what-if analysis

After you see how the DuPont formula is put together, you can start exploring different assumptions and what happens when you change the financial forecast. With the DuPont formula, you can look at how those changes are likely to affect your projected profitability, measured by your return on equity. The DuPont formula makes answering questions like the following much easier:

- What if you cut prices by 3 per cent?
- What if you increase sales volume by 10 per cent?
- What if cost of goods sold goes up by 8 per cent?
- What if you reduce your leverage by 25 per cent?

AHEAD OF THE PACK

If you get your computer and a spreadsheet programme involved in the analysis (see your local computer guru for help, if necessary), you can ask ten what-if questions and get the answers before you've time to think of the next ten.

The better you understand where your revenue and profits come from, the better prepared you are to meet financial challenges:

- Looking at different financial assumptions allows you to cover your bets in an uncertain future.
- The DuPont formula describes exactly what goes into your return on equity, which is a measure of your overall profitability.
- Using the DuPont formula, you can ask what-if questions to gauge the effects of changing your financial assumptions.

For more help on preparing for change, check out Chapter 12.

Making a Budget

The pieces of your financial forecast – the pro-forma profit and loss accounts, estimated balance sheets and projected cash-flow statements – are meant to create a moving picture of your financial situation tomorrow, next month, next year and three or even five years out. Your financial picture is likely to be much clearer in the near term, of course, and much cloudier the farther out you try to look. Fortunately, you can use the best of your forecasts to make near-term decisions about where, when and how much money to spend on your company in the future.

Making a budget for your company is one of the most important steps that you take as you prepare your business plan. Your budget, in effect, consists of a series of bets that you're willing to place, based on what you expect to happen in your industry and in the marketplace in general. Your budget spells out exactly where your company's resources will come from and where they're going to go, and helps ensure that you make the right financial decisions.

A budget is more than a collection of numbers, though. Your budget is also a business tool that helps you communicate, organise, monitor and control what's going on in your business. Your company's budget does the following things:

- Requires managers to communicate with one another so that they can agree on specific financial objectives, including revenue levels and spending targets.
- Establishes roles and responsibilities for managers, based on how much money they're in charge of bringing in and how much they're allowed to spend.

- Creates a standard way of measuring and monitoring management performance by keeping track of how well the revenue targets and spending limits are met.
- Promotes the efficient and effective use of your financial resources by making sure that all your resources point toward a common set of business goals.

Wondering what's in the budget

The rough outlines of your company's budget look a lot like your projected cash-flow statement. In fact, the cash-flow statement is the perfect place to start. Projected cash flow is a forecast of where you think the company's money will come from and where it's going to go in the future. Your budget fills in all the details, turning your financial forecast into a specific plan for taking in money and doling it out.

JARGON ALERT

The *master budget* that you create is meant to account for everything that your company plans to do over the next year or two. Although you spend your company's money in all sorts of ways, all those ways can be divided into short-term and long-term spending. In the short term, you use money to keep the business up and running every day, covering the costs and expenses of putting together and selling products and services. Over the longer term, you use money to invest in things that make your company bigger, better or more profitable.

If your company is small and you've only a few employees, a single master budget should be all that you need to keep your day-to-day finances on track as well as to make decisions in the future. When your company gets a little bigger, however, you may want to think about your company's finances in terms of more than one budget, each of which covers a different aspect of your business. You may want to create the following budgets:

- **Operating:** This budget deals with all the costs that are directly associated with putting your product or service together, such as materials, supplies, labour, utilities, services and facilities.
- **Administrative:** This budget deals with the expenses that are involved in supporting your products and services, sales and advertising, administrative salaries, phone and fax lines and travel expenses.
- **Financial:** This budget deals with the overhead expenses involved in managing your assets, including keeping your books, doing your taxes, controlling your product stock and keeping track of your debtors (the money that customers owe you).
- **Capital:** This budget deals with funds that are earmarked for the purchase of expensive items, such as new equipment, computers, a company car and additional office space.
- **Development:** This budget deals with money that is set aside for developing new products, opening branches in other cities or marketing to brand-new groups of customers.

When you need several budgets, like those in the preceding list, you use a master budget to pull all the separate budgets together and make sure that they meet your company's larger goals and financial objectives.

Global Gizmos Company put together a budget for the next two years based on a financial forecast and its projected cash flow (see Figure 11-2). The company's master budget looks a great deal like one of its cash-flow statements (flip to Chapter 10 for a comparison). But the budget goes into more detail in dividing the broad financial objectives into actual revenue and expense targets for specific company activities. The cost of goods produced, for example, is broken down into the cost of raw materials and supplies, labour, and utilities and facilities.

Figure 11-2: The master budget looks a lot like the company's projected cash-flow statement.

Master Budget

Global Gizmos Company

REVENUE AND EXPENSES	Next Year	Year After
Budgeted Revenue:		
Gross receipts on sales	£895,000	£970,000
Dividend and interest income	4,000	5,000
Total Revenue Available	**£ 899,000**	**£ 975,000**
Budgeted Expenses:		
Cost of goods produced	£ 600,000	£ 650,000
Raw materials and supplies	250,000	275,000
Labor costs	300,000	325,000
Utilities and facilities	50,000	50,000
Sales, general, and administration	£ 165,000	£ 170,000
Sales and distribution	90,000	95,000
Advertising and promotion	30,000	30,000
Product service	15,000	20,000
Accounting and office support	30,000	30,000
Interest expense	12,500	12,000
Taxes	22,000	24,000
Buildings, equipment, machinery	40,000	£100,000
Equipment and computers	35,000	25,000
Expanded warehouse	5,000	75,000
Development projects	10,000	15,000
New product development	8,000	5,000
New market development	2,000	10,000
Long-term debt reduction	2,500	2,000
Dividend distribution to owners	6,000	7,000
Total Expenses Out	**£ 858,000**	**£ 980,000**
NET CHANGE IN CASH POSITION	**£ 41,000**	**£ -5,000**

Discovering how budgets are made

Somehow, people never the right time to sit down and make a budget, they always find something much more important to do. This situation seems to hold true for household and company budgets alike. Why doesn't anybody like to do them? Often, there doesn't seem to be enough financial information around to make a budget that's of any real use. If you complete a financial forecast first, however, your company's budget is much easier to complete.

So when do you get started? If you're just starting your company, there's no time like the present. If you're already up and running, when you create a budget depends on the company's size. For really big companies, the yearly budget process may begin six to nine months in advance. No wonder that the job can feel a bit like never-ending drudgery! Most companies, however, can count on spending some serious time with their budgets three or four months before the next year gets under way.

WARNING!

Established companies can use their track records and financial histories as starting points for next year's budget. But be careful. When you're a veteran, you can easily get a bad case of budgetary laziness, using last year's numbers as a shortcut to next year's numbers. Unfortunately, you can veer off financial course before you know it. A good compass for this situation is something called *zero-based budgeting*. When you insist on zero-based budgeting, you ask everybody – including yourself – to go back and start from the bottom in preparing a budget. Rather than use last year's budget numbers, you make full use of your financial forecast, building up a new set of numbers from scratch. The process takes a little longer but is almost always worthwhile.

The process of making a budget often gets a bad name in the business world. Rather than see budgeting as being a helpful business tool, business owners often rank budgeting among the greatest evils on earth, and managers often talk about it in unprintable ways. So what gives? When the budgeting process falls apart in a company, at least one of the following things probably happened:

- The budget was handed down from above and used to control the company's managers, taking away their ability to influence the business decisions that they were ultimately responsible for carrying out.
- The budget was based on short-term thinking, ignoring the company's longer-term plans and strategic goals.
- The budgeted revenue and expense targets had nothing to do with the company's larger financial objectives or its real financial situation.

To make sure that your own company's budget doesn't suffer these fatal flaws, take a close look at two ways to put together a budget.

Top-down budgeting approach

The top-down approach to making your budget is the simplest way to work through your company's financial plans. The process pretty much begins and ends with the people who are in charge. If your company is small, you may want to invite some outside people to join you – people whom you trust, such as your banker, accountant, or maybe a close business associate. The process goes something like this:

1. **Put the finishing touches on your company's financial forecast, including pro-forma profit and loss accounts, expected balance sheets and projected cash-flow statements.**

   If certain pieces are missing or incomplete, try to get the information that you need, or make a note that the document you need is unavailable.

2. **Meet with the company's decision makers (or your trusted group, if you're self-employed) to review the financial forecast.**

   Take time to discuss general expectations about the future. Talk about the business assumptions that go into the forecast and the key predictions and estimates that come out of it.

3. **Meet again to explore possible financial alternatives.**

   Look at different sets of business assumptions and weigh their potential effects on the forecast. Continue to meet until the group either agrees or agrees to disagree about the future.

4. **Come up with revenue and expense targets for each of your company's major business activities or functional areas (whichever is more appropriate to your company).**
5. **Meet one last time after the budget is in place to review the numbers and get it approved.**

   Put together a written summary to go along with the numbers so that everyone in the company knows what the budget is, where it comes from and what it means.

Although top-down budgeting does a fairly good job when you know all the people in your company by their first names, the approach has definite disadvantages when your company gets bigger. By including only the managers at the top, you run the risk of leaving out large chunks of the organisation and losing track of your real business situation when it comes time to plug in the numbers.

Bottom-up budgeting approach

The bottom-up approach to creating your budget really is just an expanded version of the top-down process, taking into account the demands of a bigger company and of more people who have something to say. You still want to begin putting together your budget by getting a group of senior managers together. That group should still spend time coming to a general understanding of, and agreement on, your company's financial forecast, along with the business assumptions and expectations for the future that go with it. But rather than forcing a budget from the top, this approach allows you to build the budget up from the bottom.

Don't ask the group of senior managers to go on and dictate the company's budget. At this point in the budget process, the bottom-up approach means that it's time to get managers and supervisors at all levels of the company involved. The process goes like this:

1. **Meet with senior managers and ask them to review the company's broad financial objectives for each of the major business areas.**

   Try to come up with guidelines that set the tone and direction for budget discussions and negotiations throughout the company.

2. **Ask managers to meet with their managers and supervisors at all levels in the organisation.**

   Meetings can start with a recap of the budget guidelines, but discussions should focus on setting revenue and expense targets. After all, these managers are the ones who actually have to achieve the numbers and stay within the spending limits.

3. **Summarise the results of the budget negotiations.**

   If necessary, get the senior group members together again to discuss revisions in the financial objectives, based on the insights, perceptions and wisdom of the company's entire management team.

4. Go through the process again, if you have to, so that everyone at every level of the organisation is on board (or at least understands the reasoning behind the budget and its numbers).

5. Approve the budget at the top.

Make sure that everybody in the company understands what the budget means, applying the budget not only to financial objectives but also to larger business goals.

Don't forget these points about budgeting:

- Your budget spells out exactly where your company's resources will come from and where they will go.
- Your budget should be based on your projected cash-flow statements.
- Top-down budgeting is done by the top people – owners or senior managers – and works best in small companies.
- Bottom-up budgeting involves all management levels, which can mean more realistic revenue targets and spending limits.

Using ratios to improve your budget

You can use the ratios we looked at in chapter 10 to deduce any unknown future costs. Suppose that you want to get an idea of what your business phone bill is going to be in the year for which you're budgeting. If last year the bill represented 1 per cent of sales, then you can use that ratio to get a first fix on that item of expense. You can use the same technique across most areas of the budget. So if you know that you usually keep 20 days stock of your product in the warehouse, just scale up your stock to match the budgeted sales level.

At the SCORE website template gallery (www.score.org/template_gallery.html) you can find a downloadable Excel spreadsheet from which you can plan future sales and use ratios to compare performance with previous years. Once you're satisfied with your sales projection, use the profit and loss projection (at the same web link) (to complete your budget.

Analysing variances

Any performance needs to be carefully monitored and compared against the budget as the year proceeds, and you need to take corrective action if you have to, to keep the two consistent. This action has to be done on a monthly basis (or using shorter time intervals if required), showing both the company's performance during the month in question and throughout the year so far.

Look at Figure 11-3. You can see at a glance that the business is behind on sales for this month, but ahead on the yearly target. The convention is to put all unfavourable variations in brackets. Hence, a higher-than-budgeted sales figure does not have brackets, while a higher materials cost does. We can also see that, while profit is running ahead of budget, the profit margin is slightly behind (–0.30 per cent).

This situation is partly because other direct costs, such as labour and distribution in this example, are running well ahead of budgeting variances.

Flexing your budget

A budget is based on a particular set of sales goals, few of which are likely to be exactly met in practice. Figure 11-3 shows that the business has used £762,000 worth more of materials than budgeted. As more finished product has been sold, this figure is hardly surprising. The way to manage this situation is to flex the budget to show what would be expected to happen to expenses, given the sales that actually occurred. You do this by applying the budget ratios to the actual data. For example, materials were planned to be 22.11 per cent of sales in the budget. By applying that to the actual month's sales, you arrive at a materials cost of £587,000.

Heading	***Month***			***Year to date***		
	Budget	*Actual*	*Variance*	*Budget*	*Actual*	*Variance*
Sales	805*	753	(52)	6,358	7,314	956
Materials	627	567	60	4,942	5,704	(762)
Materials margin	178	186	8	1,416	1,610	194
Direct costs	74	79	(5)	595	689	(94)
Gross profit	104	107	3	820	921	101
Percentage	**12.92**	**14.21**	**1.29**	**12.90**	**12.60**	**(0.30)**

Figure 11-3: A fixed budget. Figures are in thousands of pounds. Note that figures rounded up and down to nearest thousand may affect percentages.

Looking at the flexed budget in Figure 11-4, you can see that the business has spent £19,000 more than expected on the material given the level of sales actually achieved, rather than the £762,000 overspend shown in the fixed budget. The same principle holds for other direct costs, which appear to be running £94,000 over budget for the year. When we take into account the extra sales shown in the flexed budget, we can see that the company has actually spent £4,000 over budget on direct costs. While this overspend is serious, it's not as serious as the fixed budget suggests. The flexed budget allows you to concentrate your efforts on dealing with true variances in performance.

Heading	Month			Year to date		
	Budget	*Actual*	*Variance*	*Budget*	*Actual*	*Variance*
Sales	753*	753	–	7,314	7,314	–
Materials	587	567	20	5,685	5,704	(19)
Materials margin	166	186	20	1,629	1,610	(19)
Direct costs	69	79	(10)	685	689	(4)
Gross profit	97	107	10	944	921	(23)
Percentage	**12.92**	**14.21**	**1.29**	**12.90**	**12.60**	**(0.30)**

Figure 11-4: A flexed budget. Figures are in thousands of pounds – note that figures rounded up and down to nearest thousand may affect percentages.

Budgeting for capital expenditure

Until now this chapter has concerned itself with budgeting for the coming year. Another key element of the budgeting process is to prepare a long-term *capital expenditures budget* for inclusion in your business plan. A business has to take a hard look at its long-term operating assets – in particular, the capacity, condition and efficiency of these resources – and decide whether it needs to expand and modernise its fixed assets. In most cases, a business would have to invest substantial sums of money in purchasing new fixed assets or retrofitting and upgrading its old fixed assets. These long-term investments require major cash outlays. So, a business (or each division of the business) prepares a formal list of the fixed assets to be purchased or upgraded. The money for these major outlays comes from the central treasury of the business. Accordingly, the capital expenditures budget goes to the highest levels in the organisation for review and final approval. The chief financial officer, the CEO and the board of directors of the business go over a capital expenditure budget request with a fine-tooth comb.

At the company-wide level, the financial officers merge the profit and cash flow budgets of all divisions. The budgets submitted by one or more of the divisions may be returned for revision before final approval is given. One main concern is whether the collective total of cash flow from all the units provides enough money for the capital expenditures that have to be made during the coming year for new fixed assets – and to meet the other demands for cash, such as for cash distributions from profit. The business may have to raise more capital from debt or equity sources during the coming year to close the gap between cash flow from profit and its needs for cash. The financial officers need to be sure that any proposed capital expenditures make good business sense. We look at this issue in the next three sections. If the expenditure is worthwhile, they may need to raise more money to pay for it. That may involve talking with one of the organisations we cover in ‘Ten Business-Plan Helpers’ on the For Dummies website (see ‘Where to Go from Here’ in the Introduction to find out how to download this material).

Deducing payback

The simplest way to evaluate an investment is to calculate *payback* – how long it takes you to get your money back. Figure 11-5 shows an investment that calls for £20,000 cash up front in the expectation of getting £25,000 cash back over the next five years. The investment is forecasted to return a total of £20,000 by the end of year 4, so we say that this investment has a four-year payback.

Figure 11-5: Calculating payback.

	£
Initial cost of investment	20,000
Annual net cash inflows	
Year 1	1,000
Year 2	4,000
Year 3	8,000
Year 4	7,000
Year 5	5,000
Total cash in	25,000

When calculating the return on long-term investments, we use cash rather than profit. We do so because we need to compare like with like. Investments are paid for in cash or by committing cash, so we need to calculate the return using cash, too.

Suppose that we have two competing projects from which we have to choose only one. Figure 11-6 sets out the maths. Both projects have a four-year payback, in that the outlay is recovered in that period; so this technique tells us that both projects are equally acceptable, as long as we are content to recover our outlay by year 4.

However, this is only part of the story. We can see at a glance that Project 2 produces £9,000 more cash over five years than Project 1 does. We also get a lot more cash back in the first two years with that Project 2, which must be better – as well as safer for the investor. Payback fails to send those signals, but is still a popular tool because of its simplicity.

Figure 11-6: Comparing investments using payback.

	£ Project 1	£ Project 2
Initial cost of investment	20,000	20,000
Annual net cash inflows		
Year 1	1,000	3,000
Year 2	4,000	5,000
Year 3	8,000	8,000
Year 4	7,000	8,000
Year 5	5,000	10,000
Total cash in	25,000	34,000

Discounting cash flow

A pound today is more valuable than a pound in one, two or more years' time. For us to make sound investment decisions, we need to ask how much we would pay now to get a pound back at some date in the future. If we know we can earn 10 per cent interest from a bank, then we would only pay out 90p now to get that pound in one year's time. The 90p represents the *net present value* (NPV) of that pound – the amount we would pay now to get the cash at some future date.

In effect what we're doing is discounting the future cash flow using a percentage that equates to the minimum return that we want to earn. The further out that return, the less we would pay now in order to get it.

The formula we use to discount the cash flow is:

$$\text{Present value } (PV) = £P \times 1 \div (1+r)^n$$

where £*P* is the initial investment, *r* is the interest expressed as a decimal, and *n* is the year when the cash will flow in. (For example, in year 1 $n = 1$, year 2 it will be 2 and so on). So if we require a 15 per cent return, we should only be prepared to pay £0.87 now to get £1 in one year's time, £0.76 for a pound in two years' time, and just £0.50 now for a pound coming in five years' time.

Take a look at Figure 11-7. If we use a discount rate of 15 per cent (which is an average return on capital for a business), the picture doesn't look so rosy. Far from paying back in four years and producing £25,000 cash for an outlay of £20,000, Project 1 is actually paying out less money (£15,642) in real terms, allowing for the time value of money, than we have paid out.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Cash in	1,000	4,000	8,000	7,000	5,000	25,000
NPV of cash	870	3,025	5,260	4,002	2,486	15,642

Figure 11-7: Comparing cash with the Net Present Value of that cash at 15 per cent discount rate.

Calculating the internal rate of return

NPV is a powerful concept, though a slightly esoteric one. All we know so far about our attempt to evaluate Project 1 is that if we aim for a return of 15 per cent, our returns will be disappointing. So, we move on to the next stage in our quest for a sound way to appraise capital investment proposals – calculating exactly what the return on investment will be.

To arrive at this figure, we need to calculate the actual return the project made on the discounted cash flow – the *Internal rate of return* (IRR). To do this, we need to find the value for '*r*' in the NPV formula (see the earlier section 'Discounting cash flow') that ensures that the present value of the future cash flow equals the cost of the investment. You can do this calculation by using a guessing process of trial and error, but the easiest way is to use a spreadsheet, such as the one at www.solutionmatrix.com (click on 'Download Center' and 'Download Financial Metrics Lite for Microsoft Excel') that crunches the numbers for you. In the case of Project 1, the IRR is just short of 7 per cent. You would fare little worse by leaving the money on deposit in a bank, in this case.

The IRR is a number you can use to compare one project with another to assess quickly which is superior from a financial point of view. For example, Project 2 has an IRR of 17 per cent, which is clearly better than that of Project 1, a fact not revealed by using the payback method.

The Solutions Matrix website (www.solutionmatrix.com) has a neat tool for working out payback, discounted cash flow, IRR and a whole lot more calculations relating to capital budgeting. You have to register on the site first before downloading their free capital budgeting spreadsheet suite and tutorial. Just go to the home page and click on ‘Download Center’ and ‘Download Financial Metrics Lite for Microsoft Excel’.

Part IV
Looking to the Future

'OK – Here's the business plan. Nigel takes charge of marketing, Tristram sales, Keith accounts and Psycho makes sure clients pay on time.'

In this part . . .

Wouldn't life be easier if you could predict the future? You'd never second-guess any of your decisions again. We have some good news: although you can't predict the future with much accuracy, you can prepare yourself for the future. And planning for the future – whether in life or in business – is a great way to cut down on all the second-guessing that comes later.

In this part, we help your organisation look to the future. We prepare you for change by looking closely at where changes are likely to come from. We talk about how you can anticipate changes ahead of time, assessing what effect these changes will have on your business and how likely they are to really happen.

Of course, you don't necessarily have to accept the future that you predict, so we help you shape your own future by thinking strategically. We introduce tried-and-true business strategies that have worked in the past, and show you how to create your own company strategy for the future. Finally, we explore different ways your business can grow. We look at ways to extend your product line, expand into new markets, and branch out into brand-new businesses.

Chapter 12

Preparing for Change

In This Chapter

- Defining the dimensions of change
- Tracking economic, government, technology and cultural trends
- Anticipating changes
- Using trend forecasting and scenario planning
- Assessing the effects of change
- Making use of probabilities and impacts

Life is defined by change. When we get up in the morning, we expect to live through a day that's different in all sorts of ways from the day before. As far as we know, only Bill Murray in the film *Groundhog Day* ever had to live the same day over and over again, and it almost drove him crazy.

All of us expect change. At one time or another, no doubt, each of us has said, 'I really need a change.' But you don't often hear people say that they *want* a change or *like* change. Change makes things uncertain, uncertainty makes planning difficult and people like to plan. (After all, you are reading this book.)

Companies don't want or like change, either, and they have come up with hundreds of excuses for trying to keep things just the way they are. Following are some of the top excuses:

- It's never been tried before.
- We tried it before.

- It's too radical.
- It's working fine as it is.
- We don't have the time.
- We're not ready for it.
- We can't take a chance.
- Our company's different.
- We should, but . . .
- It's impossible.

Although companies try to avoid change, they can never escape it, because change is what makes a market work in the first place. Change is the necessary evil that allows companies to form and grow, products and services to get better, competitors to come from everywhere and customers to go on shopping. In a competitive marketplace, if you stop changing, you die. Harsh, but true.

Good companies understand this fact but often have a hard time acting on it when they become successful – maybe because they've more at stake. The original Footsie 100, first calculated in 1984, represents the biggest British companies. Today, only a few of the original companies are still on the list, and many are in completely different businesses.

Across all industries, the list of companies whose stars have dimmed continues to grow:

- Woolworths (on every high street until the 6 January 2009, when the last of the 813 Woolworth stores that had operated for the best part of a century in the UK closed their doors for the last time)

- Sinclair Computers (built the personal-calculator market)
- Land Rover (the second oldest four-wheel drive brand after Jeep, was acquired by British Aerospace; then in 1994 Rover Group was bought by BMW, only to be broken up in 2000 with Land Rover being sold to Ford Motor Company; in June 2008 Ford sold both Land Rover and Jaguar Cars to Tata Motors of India)
- GEC (the colossus of UK electronic engineering metaphorphised into Marconi and all but disappeared for ever)

In this chapter, we try to prepare you for change. We start by defining the elements of change, including economic, technological, governmental and cultural trends. We go on to look at ways in which you can anticipate change by forecasting those trends and creating alternative scenarios. We also show you how to assess the possible effects of change.

Defining the Dimensions of Change

JARGON ALERT

Events and forces that are beyond your control continuously change the business conditions around you. You can't fiddle with the laws of physics or human nature, but you must keep track of changes as they're taking place. The experts would say that you're doing *environmental scans* – not the kind that the UK Government does with the Health and Safety Executive, but the kind that look at anything that may affect your business situation.

Calculating to fail

It's not just the big slow-moving companies that get swept away by change. Did you ever hear of Sinclair's pocket calculculators? In 1971, Clive Sinclair, then the boss of a tiny Cambridge hi-fi company, returned from a visit to Texas Instruments in the US armed with a new integrated circuit chip. He used this revolutionary piece of circuitry to invent the world's first pocket calculator. Up until that point, calculators had been clumsy, deskbound things that relied on mains power. His single chip calculator, which was born after six months' research, was pocket-sized as opposed to hand-held. Using the same PMOS chip as the American hand-held calculator, which required large batteries owing to the heavy demand the PMOS chip made on its power supply, Sinclair found a way of cutting the power consumption by about 20 times. This change meant that a truly hand-held calculator was possible. Sinclair Radionics made it and started the calculator boom with 'The Executive', earning £2.5 million in export revenue alone. At the time, Sinclair had a staff of about 60. By 1977, Sinclair had become world famous as a calculator manufacturer, and the 'Cambridge' programmable outsold all programmable and scientific calculators.

What happened? You guessed it: The world changed. Competitors saw a lucrative market and responded to the changing tastes of calculator users. HP and Texas Instruments quickly captured and dominated the market, while Sinclair was distracted with his Black Watch, C5 electric car and portable computer.

Although thousands of factors can influence your business environment, you can simplify matters by looking at only the ones shown in Figure 12-1. (For the details, check out the following sections.) When radical changes threaten to reshape your business, you can bet that you should look more closely at broad economic, technological, governmental or cultural trends.

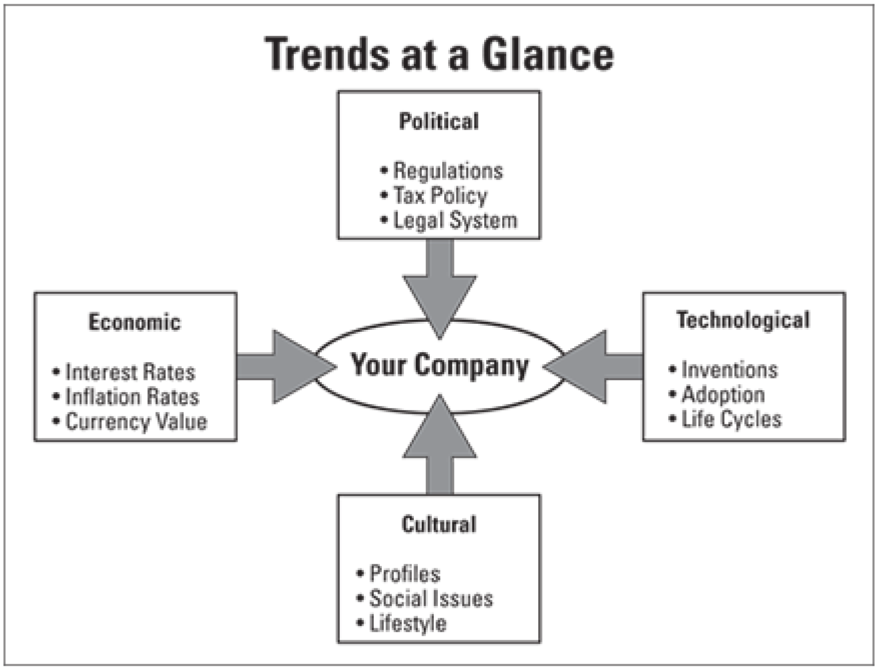
Looking at economic trends

A bank account, a mortgage, a car loan and credit cards seem to be relatively straightforward financial arrangements, which we all take advantage of every day. When combined, these financial arrangements create the glue that holds our economy together. It's not surprising that the economy, on a large scale, is complex and complicated, but the biggest mystery in economics is why no one seems to understand the basic forces at work.

Economics involves numbers, which are called *indicators.* Indicators include inflation rates, growth rates, interest rates, blah, blah, blah – the list goes on and on. Fortunately, you need to focus on only four key economic indicators, which reflect major trends in the economy:

- Gross Domestic Product, or GDP (the total value of the nation's annual production of goods and services)
- Interest rates (the cost of borrowing money)
- Inflation rates (the rate at which prices go up)
- Currency value (the value of a nation's money in the international arena)

Figure 12-1: You can break an environmental scan into four major groups of trends.



Dealing with economic uncertainty can be difficult, but economic trends are important enough that you have to keep track of them, even if your information is incomplete. What numbers should you keep your eye on? The answer depends on your business. We outline a number of trends and help you figure out the important ones you need to be aware of:

- **GDP:** The GDP (short for Gross Domestic Product) is the total value of a country's annual production of goods and services, and is the broadest measure of the economy. You probably want to keep track of the change in GDP from year to year, because that change reflects what's happening with the economy. Moderate, consistent growth in the GDP generally produces a healthy economy, with expanding opportunities for many businesses. A drop in the GDP, on the other hand, often leads to lower demand for products and services, increased competition and lower profits for everyone.

  You can't always generalise about the GDP, though. Businesses can go bankrupt even when the economy is booming, and even in the worst of times, the entertainment industry rakes in cash. Don't rely completely on the GDP; also look at how your industry and your company is performing within the larger economy.

- **Interest rates:** Interest rates are simply the cost of renting money – how much you have to pay a bank, for example, to use its cash for a certain period. Short-term rates apply when you borrow money for periods ranging from a month to two years. Long-term rates apply to loans that extend all the way out to 25-year home mortgages. As you can imagine, the cost of money affects every facet of the economy, from consumer spending to business expansion.

  In the UK, short-term interest rates are pretty much set by the Bank of England, the bank that holds the nation's bank account. With the rise of the almighty credit card, short-term rates influence shopping habits, which means that if you're thinking about starting a retail business, you have to pay special attention to short-term interest rates.

  Long-term interest rates rise and fall in the corporate and government bond markets. Long-term rates have a major impact on how easy it is for consumers to afford houses, cars and anything else that's big and expensive, because these items are usually financed with long-term loans. Long-term rates, therefore, affect consumer demand for expensive items. Long-term rates also affect business decisions such as building big new factories and buying expensive new equipment.

- **Inflation rates:** Inflation, which is a continuous rise in wages and prices, is a nasty habit that economies often suffer from. Consumers are the first to know when inflation rears its ugly head, because prices go up and money just doesn't buy as much as it used to.

When inflation is high, companies find that things are more expensive for them as well. They've to pay more for everything from materials to employees' wages and benefits. Investors turn their attention to things that have intrinsic value, such as gold, property and art – anything that protects them against money that's worth less and less. Consumers may borrow more money, partly to pay the higher prices and partly because they can pay back today's cash with money that's not going to be worth as much. Lenders know what's happening, so interest rates go up. All these factors tend to be a real drag on the economy over time, and inflation can lead to a recession if left untreated.

Not all companies suffer equally from inflation, however. If you're in the business of mining precious metal, pumping oil or selling property, for example, you can often do quite well during a period of inflation. You have to balance the broad economic trend against its effect on your own company.

- **Currency value:** In the past, the value of the pound against the US dollar, the euro, or the Japanese yen was something that only the biggest multinational companies ever had to worry about, because economies didn't rely much on the economies of other countries. That's no longer the case. In today's global economy, the rise or fall of the pound can have an enormous impact on your entire industry. Your suppliers, competitors and customers may be anywhere in the world, no matter what industry you're in or how small your company is.

  Currencies change their relative values daily for all sorts of reasons. As a result, short-term fluctuations in the value of the pound, say, are unpredictable. The effects of longer-term currency trends, on the other hand, are a little easier to predict.

When the value of the pound is relatively low, for example, British goods turn into bargains, so consumers around the world have a little extra incentive to buy British. To compete, foreign competitors have to lower their own prices (and watch profits go down) or see their share of the market get smaller. These companies also have a third option: come to Britain, build plants and produce products to take advantage of the weak pound.

The reverse is also true. A strong pound leads to bargain prices on foreign products, a shift toward imports and sometimes the relocation of UK companies abroad to take advantage of cheaper foreign currencies.

Taking heed of technological trends

You can argue that technology is good, technology is bad or technology is ugly. But no matter which side you're on, everyone agrees that technology means change. In the past 150 years, we've gone from horse and carts to space shuttles and from the mail coach to the Internet.

JARGON ALERT

But every new technology that comes along isn't guaranteed to change the world overnight. You could produce a weekly TV show on the world's funniest inventions. For the most part, the technologies that finally make it have been around for quite some time. No matter how fast a new technology takes over from the old, it usually follows a *diffusion curve* – which traces how a new technology catches on in an industry (see Figure 12-2).

The diffusion curve demonstrates that it always takes a certain amount of time for any new technology to take off. When (and if) it does catch on, the technology usually sweeps through an industry quickly, because companies don't want to be left behind. The technology reaches a plateau when most of the companies that planned to adopt the new technology have done so.

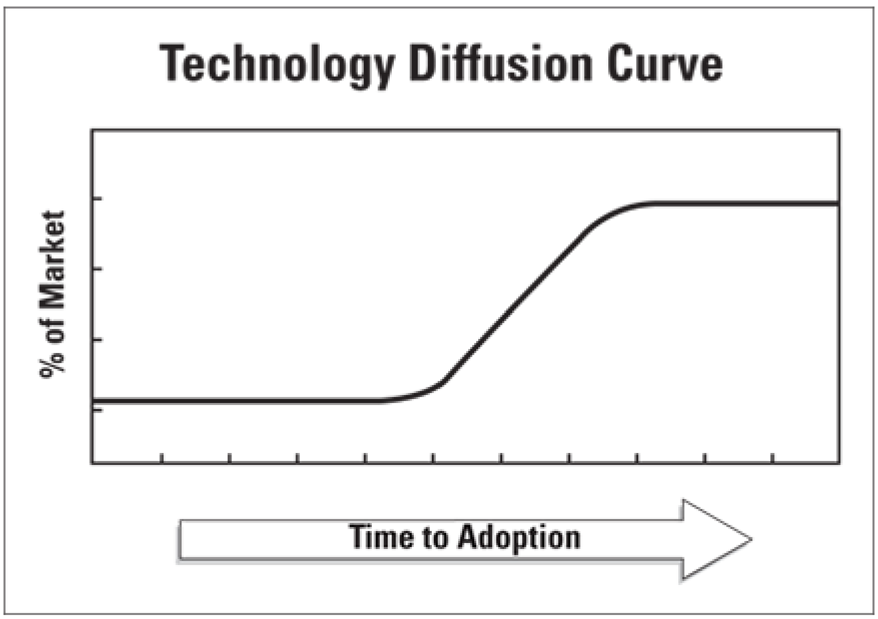


Figure 12-2: The technology diffusion curve shows that when a new technology finally takes off, it usually catches on rapidly.

Failing to adopt a new technology that's sweeping your industry can be disastrous. The advent of audio CD technology, for example, put most manufacturers of vinyl records, turntables and diamond-tipped needles out of business in a couple of years. But not all technologies live up to their early press. Just look at nuclear power and its promise of cheap, clean, unlimited energy. Plenty of the utilities that jumped on that bandwagon now find themselves saddled with hugely expensive nuclear plants – and little to show for it.

For the majority of new technologies that come along, reality lies somewhere between eureka and potential disaster. Think about the electronics industry – transistors succeeded but did not kill off their older cousins, vacuum tubes. The older technology managed to hang in there, because for certain applications, tubes are still preferred. After funeral services were held for radios (supposed to be replaced by television), glasses (considered to be outdated with the advent of contact lenses) and razor blades (not much use in the world of electric razors), these industries all turned around and actually grew. Radio stations are some of the hottest properties around, designer eyewear is definitely in and sales of safety razors never stopped expanding.

What do these examples all say about trends in technology? Although each industry is different, a few generalisations come to mind:

- Older technologies often have time to adjust to innovations.
- Older technologies can get better even after they're mature.

- New technologies usually begin by focusing on specialised markets.
- New technologies can create new customers, expanding the marketplace.
- Old and new technologies often live together for many years.

Predict when a new technology is going to come along is hard, and you can't even say for certain what's going to happen when it arrives. Computer printers are a perfect example of changing technologies. Not too many years ago, four major technologies were represented in that marketplace, each in a different stage of its *technology life cycle* – a four-stage process that every new technology goes through. Laser printers were just being released, inkjet printers were in their growth stage, daisywheel printers were in a mature market and printer-ball printers (typewriter-style) were in terminal decline.

To prepare yourself for possible changes in technology and their potential effects on your industry, review the major technologies that are currently in use. For each technology, do the following things:

- Find out which research laboratories specialise in the technology and what technical journals and publications cover and report on it. Make sure that you check out academic, private and government institutions.
- Attend major conventions and scientific meetings on the technology, and subscribe to any relevant journals and publications.

- Monitor press releases on the technology, and keep track of patents that are filed in the field.
- Compare your company's capability to adapt to and apply the technology relative to that of your key competitors.
- On a regular basis, re-examine the likelihood of a fundamental technological breakthrough, and check the status of small, step-by-step process improvements in the technology.

WARNING!

Although technologies within your own industry may be unpredictable, you can at least track them over time and take them into account as you create your business plan. The technology advances in unfamiliar areas, however, have the potential to bite you before you know what's happened. When Xerox introduced its first copier in 1959, it pretty much stopped mimeograph machine makers cold. When Sinclair came out with his hand-held calculator in 1971, with Hewlett Packard hot on his heels, slide-rule manufacturers took a fast slide into oblivion. So you want to make a point of keeping your eye on technology trends beyond your immediate industry. That way, you're better prepared for changes in your business that may come at you from out of the blue.

Poring over political trends

We're not going to grab any headlines by reminding you that government has a profound effect on your company, no matter what industry you're in. From the rules and regulations that it issues to the tax policies and legal system that it supports, the government is a major player in your marketplace. Because of its sheer size and impact, a continuing national debate goes on about how large, how wide, and how deeply involved government should be in the day-to-day running of our economy.

No matter which side of the more-or-less-government debate you’re on, you don’t have much choice but to keep track of where the discussion is heading. Government actions at any level – local, national and EU – can rapidly and dramatically alter your business environment.

What kinds of issues should you be watching for? Topics that arouse public opinion and finally lead to some sort of government reaction seem to have an eight-year cycle. During the first five years, nothing much happens. Oh, the issue may come up in an article here or an opinion poll there. But not until around the sixth year do the national press usually pick up on it in a serious way and mounting public pressure finally results in some sort of government legislation. The earlier you spot a smouldering issue that may affect you, the more time you have to prepare a response. The following companies have done just that:

- In May 2003, Rolls Royce had to change its corporate structure to prepare for planned accounting changes that the government aimed to introduce five years later. FRS 17, as the rule is known, could have curtailed the company’s ability to keep paying dividends at 2003 levels.

- In the late spring of 2006, after more than four decades of continuous service, the 'meals on wheels' service aimed at housebound pensioners and those too ill to cook for themselves changed out of all recognition. The government outlined plans to give service users credits to be spent buying takeaway meals from local Chinese, Indian and pizza outlets. Local councils offered to provide pensioners with microwaves so they could cook their own frozen pre-prpeared meals. The professed aim was to provide more choice for users,but in fact it was a cost-saving exercise to help the government deal with the vaste increase in the population of over 70s and 80s.
- In 2009, the UK financial sector was just starting to come to terms with the fact that large swathes of the banking system had or were likely to be nationalised. The ramifications affect every aspect of commercial life for decades to come and in ways that are only slowly beginning to emerge. Try to imagine, for example, Tesco, Morrison and Sainsbury being taken into state ownership, along with BP and Shell and you get a feel for the scale of change to come!

What parts of 'government' should you pay most attention to? Government can be thought of as having four major levels – the EU (European Union), national government, local government and the judiciary – and each can affect your company:

- **The European Union (EU):** The European Union was formally established on 1 November 1993. The EU is the most recent in a series of European co-operative organisations that originated with the European Coal and Steel Community (ECSC) of 1951, which became the European Community (EC) in 1967.

  The EU countries co-operate in three areas, often referred to as pillars. At the heart of this system is the

EC pillar with its supranational functions and its governing institutions. The EC pillar is flanked by two other pillars: Common Foreign and Security Policy (CFSP) and Justice and Home Affairs (JHA).

Now, all the unpopular legislation coming out of the EU, or from 'Brussels', as the EU is known, influences every aspect of corporate life from the hours you can expect people to work, to the wording of your job advertisement. Its rules impact on how you can produce and distribute products and even on how you can protect ideas and inventions.

How may the EU's agenda influence the future of your industry?

- **National government:** Westminster, the shorthand for government in the UK, still holds sway over most legislation and still has influence over how Brussels' rules and regulations should be enacted, if at all. In the Thatcher years, the aim was to lower taxes, slim back public services and get out of industries' way. The current Coalition government seems to be on a diametrically opposite tack. A tax rate of 50 percent is on the horizon in the UK, while in many other European countries they contracted. The government is the largest consumer of advertising and consultancy services, among many others. Today, legislatures in Wales, Northern Ireland and Scotland have assumed some of the central government's powers.

  How do you think that the government's agenda may impact on your industry?

- **Local government:** When London's mayor, Ken Livingston, introduced his congestion charge soaking every central London visitor with a £5-a-day bill, it wasn't long before easyCar entrepreneur Stelios Haji-

Ionnau's car rental business took a bath. The car hire market in central London dipped substantially. Mr Haji-Ionnau cited 'Red Ken's' tax as the primary reason for laying of half his London staff, reducing opening hours from 16 to 8 a day, and trimming back his fleet of 3,500 cars.

Local governments can be councils or authorities at the county, borough, or district level. Local councils are controlled by laws and policies established by the central government, particularly concerning budgets and spending. Councils at the local level in Britain are responsible for police and fire services, roads, traffic, housing, building regulations, libraries, environmental issues and schools paid for by direct grants from central authorities.

- **Judiciary:** Britain has a long judicial history. The British legal system relies on common law, which is based on custom and on decisions in previous legal cases, called precedents. Common law originated in the twelth century, growing out of the rules and traditions that ordinary people had worked out over time. Through the centuries, common law evolved as it incorporated legal decisions made in specific cases, and it remains the basis of British law except when superseded by legislation. The responsibility of reviewing legislation to determine its constitutionality falls to Parliament.

The Law Lords, the final court of appeal, decided that the Equitable Life insurance company, for example, did not treat all its members as equal, having given one group special rights in terms of guaranteed pension annuities. This decision in effect caused the business to cease taking in new business and all but close its doors.

Although we focus here on the UK government, the governments of other countries can create just as many complications.

You may need a little help in picking out the government activities and trends that are most likely to affect your own business environment. Almost every industry has a trade association, along with an industry newsletter or two. You can also look at local Chambers of Commerce. These organisations devote much of their time and resources to keeping tabs on – and influencing – what's going on at all levels of government. Check in with your trade association or Chambers of Commerce from time to time.

Considering cultural trends

Take two frogs and a pan. Place the pan on the stove and bring a small amount of water to boil. Drop one of the frogs into the pan. The frog most likely jumps out of the pan, onto the floor and out the door. Let it go.

Place the pan back on the stove, this time filled with cold water and the second frog. As the water slowly heats, the frog sits there agreeably, never noticing that the temperature's rising. (Don't try this experiment at home unless you're planning to have frogs' legs for dinner.) The moral? When you ignore the slow changes that are taking place around you, you boil.

Cultural changes don't happen overnight (after all, the greying of the Baby Boomers has taken many years). But the glacial speed of these trends reflects the glacial forces that lie behind them. The real danger lies in ignoring these trends simply because you can always worry about them later. Well, later always gets here sooner than you realise. Consider the cultural shifts described in the following sections:

The juice on Jewson's

For decades, Jewson's operated a chain of old-fashioned building-supply shops in Cambridgeshire. Their first provisions shop opened in 1836, but they quickly changed tack and concentrated on meeting the needs of the fast-growing army of self-employed contractors or small-time builders, who sprang up on the back of the wealth created by the Industrial Revolution. Then, in the late 1970s, the company recognised an emerging trend that the company was ill-prepared for: the growing ranks of do-it-yourselfers. These people weren't at all like Jewson's traditional customers. They didn't know what they were doing, they expected a great deal of helpful advice, and they wanted lots of options.

Jewson's prepared for change. Today, you can find its 500stores throughout the whole country. The stores don't look anything like they used to; most of them have been built or extensively refurbished over the past decade or so. Inside, you can find doors, windows, cupboards, counters, fixtures, wood, tools, plumbing materials, bathroom fittings . . . you name it. If you need help, you can take advantage of kitchen planners, interior designers and even gardening and landscape experts, all for free. Their Sustainable Building Guide launched in November 2010 includes details on the green credentials of their products, updates on government incentives and initiatives and on the company's new initiative, The Greenworks Training Academy.

Today, more than 60 per cent of Jewson's customers are retail buyers rather than contractors. Many of the customers are women and they come back because of the service that they receive. Customer service is a top priority, and every employee receives extensive and continuous training. Their 10,000 staff members have all been chosen for their knowledge and experience within all trades. Their customers can approach them with any query, rely on their advice and know that they are getting the best service available.

- **Demographic changes:** *Demographics* refers to the general profile of a specific population – anything from your company's customers to the citizens of a nation. Demographic data include things that you may find in a national census form, such as age, gender and family size. See later in this chapter for more on demographics and how to anticipate the problems and opportunities that changes throw up.
- **Social changes:** A society is made up of the combined values, customs and traditions that its people hold in common. Social behaviour changes over time, of course, but people tend to give up their traditions slowly and grudgingly. American children still have the summer off from school, for example, even though the children are no longer usually needed to help in the fields.

  But what happens to customs and traditions as the population changes – as people move from place to place, as families start to look different and as new citizens bring their own customs and traditions? Any change in broad social behaviour, no matter how slowly it occurs, can have a dramatic effect on your company and on industries across the economy.
- **Lifestyle changes:** Changes in the way people live their lives affect how they work, what they buy, how they play and where they live. About ten or 15 years ago, for example, the health-and-fitness craze caught on in the UK. Today, the industry includes the makers of sports shoes, sportswear, exercise equipment, tennis rackets,

mountain bikes, kayaks, yogurt, diet drinks, bottled water and many other products.

Other major lifestyle changes that affect all sorts of industries include:

- Growing gender equality in every area.
- At-home companies and telecommuting.
- At-home shopping, education and entertainment.
- Multiple-career professionals.
- Alternative family units.
- Workers who continue to work past retirement age.
- Workers who opt for early retirement.

When you define the dimensions of change, you have to look at trends in a number of areas:

- In a competitive marketplace, if you ignore change, you lose.
- The four major dimensions of change are economic, technological, governmental and cultural trends.
- To track economic changes, keep an eye on the Gross Domestic Product (GDP), interest rates, inflation rates and currency value.
- Technological changes are driven by the diffusion of innovation (how fast new technologies catch on).
- When the government changes its mind on regulation, taxes or spending, shock waves can transform entire industries.

- Cultural trends are like glaciers – slow-moving but powerful enough to flatten you if you don't pay attention.

Anticipating Change

Obviously, you're going to find it hard just to keep track of what's going on all around you, never mind trying to anticipate what's going to happen in the future. The point is not to predict the future, however; we can leave that to the palm readers and the people who gaze into crystal balls. The point is to have a better understanding of what *may* happen so that you can be better prepared than your competition.

To do that, you need to sort out which of the many trends – economic, technological, governmental and cultural – are going to turn into the megatrends that make tomorrow's entrepreneurs rich. What trends are going to influence your industry, your strategies and the competition?

Start by turning to the professionals and seeing what they have to say. Scan the publications that make it their business to follow these trends. After a while, you can judge which of them are most useful. Along with *The Economist* and the *Financial Times,* try *The Wall Street Journal, Business Week, Forbes* and *New Scientist* among others.

You should also check out organisations that specialise in the future, including The Centre for Policy Studies (CPS), The Fabian Society and the Policy Studies Institute in the UK and The Aspen Institute, Global Business Network, Foresight Institute, Institute of the Future and Millennium Institute in the US.

Trying out trend forecasting

You can use several tricks of the trade to peer into the future and see whether a particular trend is likely to continue. Given the nature of the challenge, however, you may not want to rely on any one of these tricks too heavily. Each approach provides its own unique look forward.

Extrapolation

Sometimes, you can use mathematical sleight of hand to project a historical trend into the future. This process, called *extrapolation,* works particularly well for trends that aren't changing rapidly and can be measured in numbers. The idea's fairly simple. You take your favourite trend (the inflation rate, for example) and assume that this trend is going to change in exactly the same way as it has in the past. Certain economic measurements, customer profiles and even a few technology trends are likely candidates for extrapolation.

The easiest way to extrapolate a trend is to find someone who's already done it for you, which means tracking down a magazine article or an academic paper. But don't despair if you have to do the job yourself. Computers make the job much easier, and the current crop of spreadsheet programs have buttons that you can click to generate an extrapolation. You need historical data to get started, of course.

Any sudden changes in a trend really mess up your extrapolation. Unfortunately, many trends are getting less and less predictable these days, which makes forecasting more difficult – and the abrupt changes are exactly the ones that your business needs to know about ahead of time. Judgement forecasting and Delphi studies may help you to predict some of these changes.

Judgement forecasting

Judgement forecasting relies on the information, experience and gut feelings of the people in and around your company to predict specific trends. Use a short questionnaire or a brainstorming session to get your managers, employees and even suppliers and customers to give you their judgements about where trends are likely to head.

Judgement forecasting isn't mathematical; you can use it to make predictions about things that can't be described in terms of numbers. You should do some sort of judgement forecasting periodically, just so that you can stay one step ahead of the most recent events and changes in your business environment.

Delphi study

A *Delphi study* is a set of questionnaires that you put together to send to a group of experts when you've a particular question about the future. Then you summarise the answers and send the questionnaires out again to get another set of responses. A Delphi study is really a way to bring in the big guns without having to get them together in the same room.

Suppose that you want to forecast trends in the use of solar energy to heat, cool and provide electricity for entire housing developments. You know that the issue is best addressed by experts in the solar-energy field. Ideally, you'd like to bring a group of these experts together for a face-to-face discussion of the issues, but that meeting would cost big bucks and would be hard to organise. Instead, you can use a Delphi study. Follow these steps:

1. **Send a questionnaire to each of your experts, asking for her judgement on an issue.**

   For this example, the issue is solar energy and the feasibility of solar-driven housing developments in the future.

2. **Read the completed questionnaires when the experts return them to you.**
3. **Summarise the experts' forecasts, including majority judgements, minority opinions and any dissenting views.**
4. **Send the summary back to each of the experts, along with a second copy of the questionnaire.**

   You ask the experts to review the first-round summary and then fill out and return the questionnaires again. Some experts may alter their original judgements and respond to new issues and concerns that are raised.

5. **Continue the process of responding and getting feedback until you're satisfied that a consensus has been reached.**

Seeking out scenario planning

Sometimes trends are too unpredictable or too numerous to track, so you can't project a single view of the future that seems to make any sense. *Scenario planning* allows you to imagine several complete versions of the future and consider how each version may affect your company's fortunes.

Start with a trend (the inflation rate, for example), and think about how you may create two or three alternative scenarios, based on different levels of inflation in the future. (For more information on inflation, refer to the section 'Economic trends' earlier in this chapter.) Try to include a fairly complete description of what your business environment may look like in each case.

Don't be too surprised if you feel the need to introduce another important trend into your scenario. Maybe your company's future is also tied to government regulations that are to be announced sometime in the next five years; you can put together another set of scenarios that involve those regulations. But if you've three possibilities for regulation, with three possible levels of inflation, you now have nine scenarios to juggle. Obviously, this situation can get out of hand rather quickly.

Experienced scenario jugglers are quick to point out the wisdom of working with no more than three or four scenarios at a time. Rather than add trend after trend into a growing set of scenarios, limit yourself to three complete scenarios based on different views of your industry in the future:

- A scenario based on an optimistic view.

- A scenario based on a pessimistic view.
- A scenario based on the most likely view.

You may decide that low inflation, minimum regulation and a technology breakthrough create an optimistic scenario, while high inflation, heavy regulation and no technology breakthroughs are the pessimistic view. The most likely view probably falls somewhere in between.

You may decide to create a business plan for the future by looking backward and doing what you've always done in the past. That method is easy, comfortable – and dangerous. Scenario planning isn't meant to predict the future; its real value lies in offering you new options and a wider range of possibilities to think about. Different business scenarios stimulate your imagination and bring to life compelling glimpses of your company's future.

Remember the following points about forecasting:

- Effective plans don't have to predict the future, but they do have to anticipate change.
- One way to forecast trends is to go by the numbers, using mathematical tricks such as extrapolation.
- You can look to the smart people around you to brainstorm and make judgements about what the future holds.
- When you've too many uncertainties, try several scenarios: optimistic, pessimistic and most likely.

Looking at demographic time bombs

One aspect of forecasting that underpins all business plans is the overall size of a population and the numbers within each age group. Ultimately, people create the consumption for everything produced or delivered. Babies need maternity services, children need schools, teenagers need mobiles, families need homes, pensioners need – well, pensions!

The theory of demographic forcasting is fairly straightforward. If you know that the current population of a country or market and their ages, and something of current mortality rates, you can roll that data forward. For example, it's reasonably certain that all children who survive childbirth in the UK (all bar five in a thousand) are highly likely to be around in 79 years time. In Zimbawe, 52 children per thousand die in childbirth and those who survive only live for an average of 39 years. Such data underpins demographics, coupled with a number of factors. These factors include medical breakthroughs and changes in lifestyle. For example, an increase in alcohol consumption during the Russian Federation's violent shift from communism lowered average life expectancy by five years. Other factors to take into account are changes in the birth rate and net immigration.

You can find plenty of data from which to make projections and much of it is reliable enough for business purposes. For example, in 1884 the Swiss Bureau of Statistics estimated that the population of various European countries by the year 2000 with remarkable accuracy. For Italy, the population was expected to grow from 28 million to 56 million, and it actually grew to 58 million. For France, the projection was from 36 million rising to 64 million, and the population actually turned out at 59 million.

You can draw on plenty of help with projecting populations. The UK government provides data for free at the National Statistics website. (www.statistics.gov.uk/hub/population/index.html), as do most governments. Euromonitor (www.euromonitor.com/Future_Demographics) produces the projections for every country, but at a price.

Gary King of Harvard University provides his 325 page book on demographic forecasting for free online at http://gking.harvard.edu/files/smooth._pdf. http://gking.harvard.edu/sites/scholar.iq.harvard.edu/files/gking/files/prelims_0.pdf.

He has also provided a full length video introducing the book to a general audience without maths (http://webapps.sph.harvard.edu/content/ DeansDis.Lecture_9-29-05_2005-09-29_04-08-PM.htm) and a free open source software package, YourCast (http://gking.harvard.edu/yourcast) that lets you make demographic forecasts using your own assumptions.

Doing a PEST analysis

PEST (political, economic, social and technological) is a framework that helps pull together all the external factors that influence change. Often two additional factors, environmental and legal, are added, changing the acronym to PESTEL analysis. Table 12-1 gives the gist of a PESTEL analysis.

Table 12-1 A PESTEL Analysis Framework

Factor	*Event*	*Impact*	*Timing*	*Proposed response*
Political				
Economic				
Social				
Technological				
Environmental				
Legal				

Assessing the Effects of Change

All sorts of changes take place around you all the time. Some of the changes have a big effect on your company; you scarcely notice others. Some of the changes are obvious and predictable; others come out of nowhere. The critical questions for your company are:

- Which changes will actually take place?
- What do the changes mean for your industry?
- What do the changes do to your company?

Rolling the dice

JARGON ALERT

What are the odds that something – a specific event, a particular activity, a given scenario – will actually occur in the future? Fortunately, you don't have to dust off the crystal ball just yet. *Probability theory* is a respectable branch of mathematics that's been around for a long time.

Probabilities are important, because they give you a rough idea about the likelihood that a prediction comes true.

You probably understand more about probability theory than you think. If you toss a coin, for example, you probably have a gut feeling that half the time, you get heads. The odds of getting heads, then, are 1 in 2. What other probabilities can you come up with? Here are some coin-tossing odds:

- Probability of tossing heads: 1 in 2.
- Probability of tossing two heads in a row: 1 in 4.
- After tossing three heads in a row, probability of tossing another heads: 1 in 2.

JARGON ALERT

These probabilities are all based on something called *random statistics*. Every time you toss a coin, the outcome is going to be random; it doesn't depend on anything else that happened before or around it. That's why it doesn't matter whether you've already tossed three heads in a row; your next toss is still random, and tossing heads is still a 50–50 possibility.

But many activities and events aren't at all random. The weather, for example, is certainly unpredictable and subject to change (that's why we talk about it so much). But weather is not random; weather is influenced by all sorts of factors and forces. What's the probability that the thermometer hits the 30 degrees mark tomorrow? The answer depends on your location and the season. The probability is higher in summer than in winter, and higher still during a heatwave.

Many of the business trends that we look at in this chapter behave much like the weather; they're unpredictable and subject to change, but not random. The probability that inflation, for example, is going to reach a certain level over the next six months depends on past inflation rates as well as on underlying factors that include economic demand, factory output levels and wage pressures. That's why the experts tell us that they can forecast inflation, and their track records are about as good as those of weather reporters. Still, everybody's interested in forecasts, because they're better than guesses.

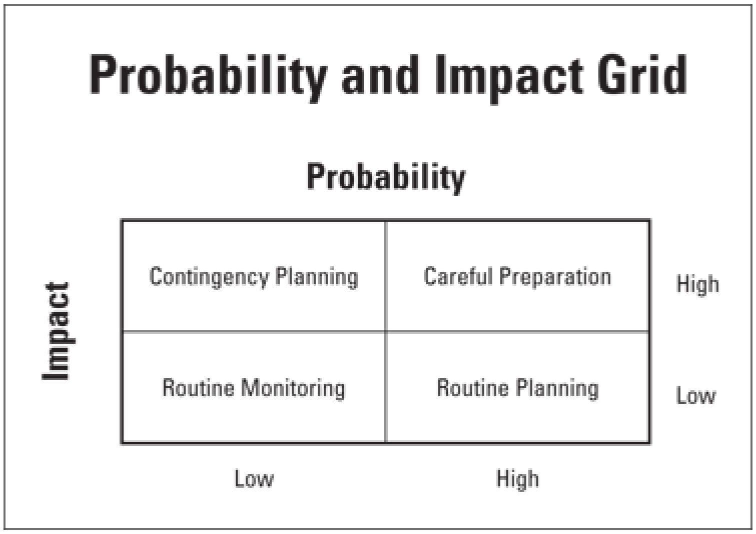
Winning or losing

The impact that a trend or an event will have on your business tells you just how hopeful or worried you should be if predictions actually do come true. A trend may be the best thing to happen to one industry and a complete disaster for another. An event may create a major opportunity for your company or have no noticeable effect at all.

Review your own business trends and scenarios, and place significant events or possible outcomes in one of the four probability/impact categories shown in Figure 12-3. Each category requires a different level of planning and preparation on your part:

- High probability, high impact events demand careful preparation.
- High probability, low impact events call for routine planning.
- Low probability, high impact events require contingency planning.
- Low probability, low impact events suggest routine monitoring.

Figure 12-3: The Probabilty and Impact Grid divides events into categories based on how likely they are to occur and what effect they may have.



If you need help figuring out which trends and scenarios belong in which categories, you can always open your wallet to the experts. But first, see what you can do on your own. Get together a group of your colleagues and maybe one or two of your best customers for a brainstorming session on the future of your company. You may be surprised by the insights that can come out of this kind of get-together when you start the ball rolling. Here's what you do:

1. **Give the group a fixed amount of time to review the trends and scenarios that you come up with and to throw in any new ones of their own.**
2. **Have someone make a list as the group generates ideas.**
3. **Put the complete list of trends and scenarios in front of the group.**
4. **Rank trends and scenarios, based on their potential to affect your company's future.**
5. **Rank these trends and scenarios again, this time in terms of the probability that they will actually occur.**

6. Divide the trends and scenarios into the four probability/impact categories (refer to Figure 12-3).

The Probability and Impact Grid tells you where to concentrate your efforts. Putting the trends and scenarios that you come up with in probability/impact categories gives you a place to begin. You can prepare for change, allocate time and resources, and plan for possible events based on a practical combination of probabilities and potential effects on your company.

A few last points on probability and impact:

- You have to do more than just predict change; you also have to figure out what it means for your company.
- Probabilities tell you the likelihood that your best guess will come true.
- By weighing the impact of your best guess, you know whether to be excited, worried or unconcerned.
- Looking at probability and impact together gives you a better idea of how to plan.

Chapter 13

Thinking Strategically

In This Chapter

- Discovering why strategy can make a difference
- Exploring the low-cost leadership strategy
- Applying differentiation strategies
- Focusing on a focus strategy
- Examining other strategic alternatives
- Coming up with your own strategy

In this chapter, we help you formulate a strategy for your company that's in keeping with its basic mission. First, we explore why strategy is so important to the business-planning process. We examine what it means to have a strategy and when that strategy works best, and introduce several basic strategies that you can apply across many industries. These off-the-shelf strategies include efforts:

- To be the low-cost provider.
- To differentiate your products.
- To focus on specific market and product areas.

We talk about several other general strategic alternatives as well, answering questions such as 'What does it mean to become more vertically integrated as a company?' and 'How should you act when you're the market leader or a market follower?' We also give you pointers about creating a strategic blueprint for your own company.

Making Strategy Make a Difference

Some companies think that *strategy* and *planning* are four-letter words. Those companies would never think of using either term in the context of their own organisations. It isn't that these companies don't move forward; they don't talk much about it ahead of time. So why do the two terms have such bad reputations in certain quarters? More than likely, because they've been misunderstood or applied incorrectly. *Strategy* and *planning* have become such buzzwords in today's business world that their real meanings are easily lost in all the muddle surrounding them.

> The colourful and outspoken Wall Street trader Alan 'Ace' Greenberg, head of the Bear Stearns brokerage house, is no fan of strategic planning. He has even gone so far as to suggest that because strategic plans have such poor track records, he should establish a Backward Planning Committee to guarantee his company's success. What a card. Still, although Greenberg won't give business planners the time of day, he has a strong personal vision, strategy and plan to make Bear Stearns successful over the long haul.

At the opposite end of the playing field from Ace Greenberg is a fictional character named Joe Clueless, who doesn't give a hoot about the future. Joe doesn't have a personal vision or a strategy. He doesn't have his own plan, because he's an opportunist. Maybe he's in the right place at the right time, right now. But no one can consistently survive on short-term breaks alone. As the old saying goes:

Luck sometimes visits a fool, but it never sits down with him for long.

The process of strategic planning creates a framework and a discipline to guide those of us who find ourselves somewhere in between Ace, who has built-in business radar, and Joe, who can't be bothered. We know that strategic planning works, because we've seen it with our own eyes. We've also seen where a lack of strategic planning can lead. Study after study demonstrates that businesses without a current business plan are likely to fail – 78 per cent go under due to lack of a well-developed business plan according to the National Business Association (`www.nationalbusiness.org/nbaweb/Newsletter2005/2029.htm`). Research from Cranfield shows that firms with a well prepared business plan are significantly more likely to add value to their enterprise (`www.som.cranfield.ac.uk/som/p16445/Knowledge-Interchange/Management-Themes/Entrepreneurship-and-Business-Growth/Business-Planning-Research-and-Practice`).

Thinking what strategy means

The word *strategy* comes to us from the ancient Greeks and translates literally as *the art of generalship*. When you compete, you probably feel that you're suiting up for battle, jousting with your competitors for the hearts and minds of customers.

Modern definitions of the word are even less precise, so we're proposing our own standard definition of *strategy* in the business arena. A strategy does the following things:

- Describes how to reach the goals and objectives that you set for the company.

- Takes into account the personal and social values that surround your company.
- Guides the way that you allocate and deploy your human and financial resources.
- Creates an advantage in the marketplace that you can sustain, despite intense and determined competition.

Putting together a strategic business plan requires you to gather data, analyse the information, and then do something with it – something more than just reformatting it, printing it and packaging it in a tidy report titled ‘The Five-year Plan’. In most cases, that kind of report begins and ends with numbers – revenue projections, cash flows, expense allocations and the like, which are things that don’t help you figure out what to do next. Reports like this one are sure to fall victim to the dreaded SPOTS (Strategic Plans on Top Shelves) syndrome: they gather dust and little else. These reports don’t represent strategy or planning; they represent a waste of time.

What can you do to make sure that this fate doesn’t happen to your business plan? For one thing, a healthy dose of plain old common sense works wonders as you pull all the pieces together to create your strategy. Experience in your industry and some nous are advantages, too. Unfortunately, we can’t give you any of these gifts. But we can offer you solid advice about laying out your strategy, including hints that make you look like a planning pro.

AHEAD OF THE PACK

Keep the following questions in mind as you begin to formulate your strategic plan:

- What markets and segments does your company plan to compete in?

- Which products and services will your company develop and support?
- Where is your company's competitive advantage in these markets and products?
- How will your company sustain that competitive advantage over time?

The answers that you come up with go a long way toward keeping your strategy focused and on target, so you want to return to them from time to time at each phase of the planning process.

Wondering when strategy works

Strategy works when you have a process to ensure that planning is consistently tied to the ongoing operations of your business. If strategic plans fail, it's usually because they don't seem to be relevant to the issues and problems at hand. Strategy and planning get linked with committee meetings, bureaucracy, overheads and all those other barriers that are thrown up to ensure that results aren't achieved. As a result, strategy and planning are seen by some companies as a part of the problem, not a solution.

Strategy works best when strategic planning is integrated into every aspect of your business, every day of the week and every week of the year. An ongoing strategic-planning process means that you do the following things:

- Always question what makes your company successful.
- Continually observe customers and markets, tracking their wants and needs.

- Relentlessly examine the competition and what they're up to.
- Steadily work at maintaining your competitive advantage.
- Continually search for ways to leverage your core competence. (Check out Chapter 9 for the definition of core competence.)

Some managers may do all these things automatically and intuitively. But if you want to make sure that strategy and planning are carried out in all parts of your company, you have to create a framework to ensure that it happens. When you make strategic planning a basic responsibility, you get the added benefit of including all levels of employees in the planning process. Employees often have different and equally valuable viewpoints about shaping strategy, and a strategic-planning framework ensures that their voices are heard.

MANAGER'S TIP

To start the ball rolling in your own company, pull together a group of employees who represent different functions and various levels in your organisation. Meet on a regular basis to talk about strategy and planning. Concentrate on how to set up a framework to promote strategic thinking, and focus on problems associated with the strategic-planning process itself. Then group members can take what they learn back to their own areas and begin to integrate strategic planning into the way that they do business.

Keep these points in mind when thinking about your company's strategy:

- Strategy is the art and science of creating a business plan that meets your company's goals and objectives.
- Strategy works best when strategic planning is integrated into every aspect of your business.
- Don't fall victim to the SPOTS (Strategic Plans on Top Shelves) syndrome.
- On average, small companies that have strategic plans have 50 per cent higher revenue and profit growth than companies that fail to plan.

Applying Off-the-Shelf Strategies

Maybe you think that your company's situation is absolutely unique and the issues that you face are one-of-a-kind. Does this fact mean that your strategy and business plan have to be unique as well? Not entirely. If you look through a microscope, every snowflake is different. But snowflakes have a great deal in common when you stand back and watch them pile up outside. Companies are like snowflakes. Although all the details give companies their individual profiles, companies and industries in general display remarkable similarities when you step back and concentrate on their basic shapes.

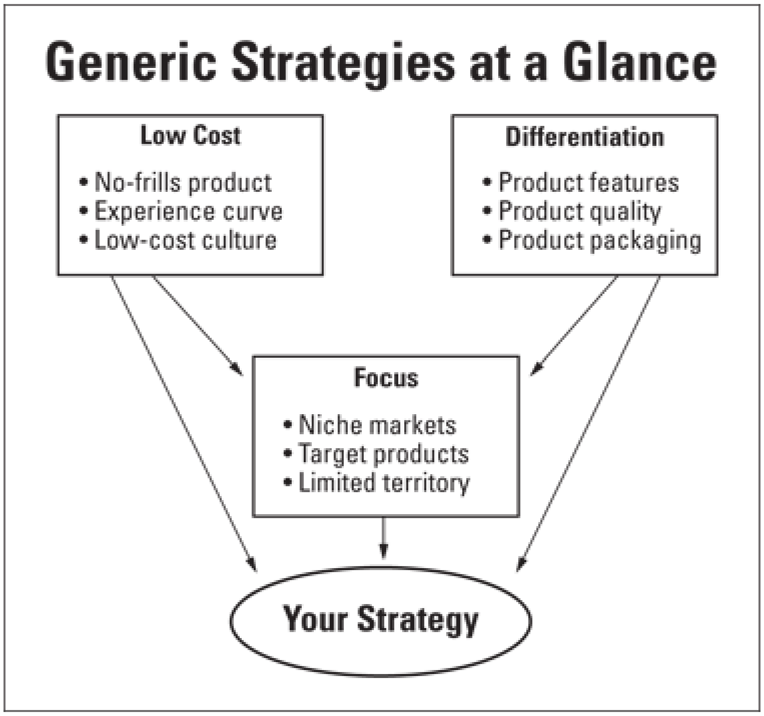
Master business strategist and Harvard University professor Michael Porter was one of the first to recognise, and take an inventory of, standard business profiles. Based on what he saw, he came up with three generic approaches to strategy and business planning. These *generic strategies* are important because they offer off-the-shelf answers to a basic question: What does it take to be successful in a business over the long haul? And the answers work across all markets and industries.

Generic strategies boil down to the following standard approaches (highlighted in Figure 13-1):

- **Cut costs to the bone.** Become the low-cost leader in your industry. Do everything that you can to reduce your own costs while delivering a product or service that measures up well against the competition.
- **Offer something unique.** Figure out how to provide customers with something that's both unique and of real value, and deliver your product or service at a price that customers are willing to pay.
- **Focus on one customer group.** Decide to focus on the precise needs and requirements of a narrow market, using low cost or a unique product to woo your target customers away from the general competition.

It's not surprising that cutting costs and offering something unique represent two generic strategies that work almost universally. After all, business, industry and competition are all driven by customers who base their purchase decisions on the value equation – an equation that weighs the benefits of any product or service against its price tag. (Refer to Chapter 7 for more information on the value equation.) Generic strategies merely concentrate your efforts on influencing one side of the value equation or the other.

Figure 13-1: Generic strategies involve deciding whether to become the low-cost leader or provide unique customer benefits.



Learning low-cost leadership

Becoming the low-cost leader in your industry requires the commitment and coordination of every aspect of your company, from product development to marketing, from manufacturing to distribution, from raw materials to wages and benefits. Every day and in every way, you track down and exterminate unnecessary costs. Find a new technology that simplifies manufacturing? Install it. Find a region or country that has a more productive labour force? Move there. Find suppliers to provide cheaper raw materials? Sign 'em up.

A cost-leadership strategy is often worth the effort because it gives you a powerful competitive position. When you're the low-cost leader, you call the shots and challenge every one of your competitors to find other ways to compete. Although the strategy is universal, it works best in markets and industries in which price tends to drive customer behaviour – the bulk- or commodity-products business, for example, or low-end, price-sensitive market segments.

The following sections describe the ways in which you can carry out a cost-leadership strategy.

No-frills product

The most obvious and straightforward way to keep costs down is to invoke the well-known KISS (Keep It Simple, Stupid!) principle. When you cut out all the extras and eliminate the options, your product is bound to be cheaper to put together. A no-frills product can be particularly successful if you're able to match it with a market that doesn't see any benefit in (or is even annoyed by) other products' bells and whistles – the couch potatoes whose video recorders sport a flashing 12:00, for example, or famous-writers-to-be who are baffled by their word processors.

In addition to removing all the extras, you can sometimes take advantage of a simple product redesign to gain an even greater cost advantage. Home developers have replaced plywood with pressed board, for example, to lower the costs of construction. Camera makers have replaced metal components with plastic. And, of course, you can always take the Pizza Express solution; the company reduced costs at one point simply by making its pizzas a wee bit smaller.

Stripped-down products and services eventually appear in almost every industry. The most obvious examples today are:

- No-frills airlines such as easyJet and Ryanair

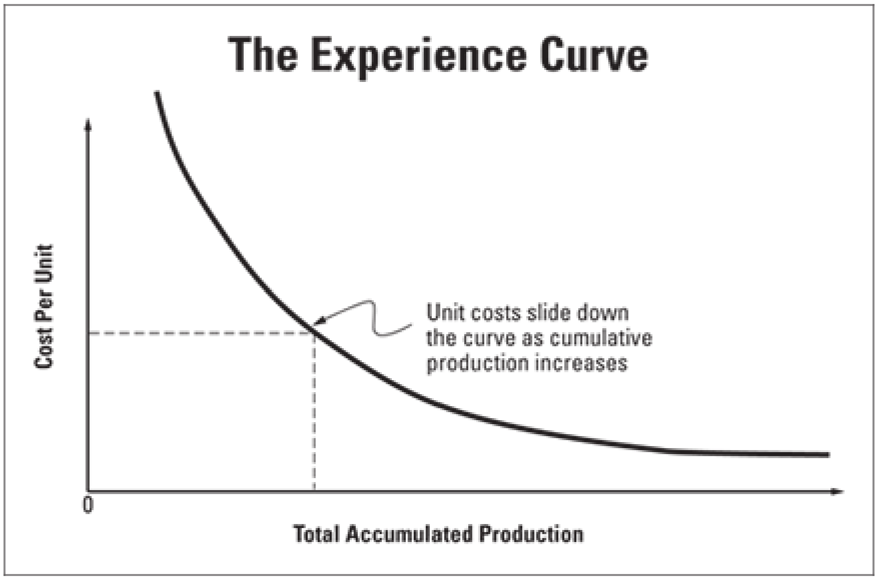
- Warehouse stores such as Aldi, Costco and Lidl, which offer a wide selection, low prices and no help
- Bare-bones brokerage houses such as Hargreaves Lansdown and TD Waterhouseand Quick & Reilly, which charge low commissions on trades without any hand-holding or personal investment advice

Experience curve

Cost leadership is often won or lost based on the power of the *experience curve,* which traces the declining unit costs of putting together and selling a product or service over time (see Figure 13-2).

The curve measures the real cost per unit of various general business expenses: plant construction, machinery, labour, office space, administration, advertising, distribution, sales – everything but the raw materials that make up the product in the first place. All these costs combined tend to go down over time when they're averaged out over all the products that you make or services that you provide.

Figure 13-2: The experience curve traces the declining unit costs of putting together and selling a product as total accumulated production increases.



The underlying causes of the experience curve include the following:

- **Scale:** *Scale* refers to the fact that you've fixed business costs, which are fixed in the sense that they're not affected by how much of your product you make and sell. (Fixed costs usually include such things as your rent, the equipment that you buy and some of your utility bills.) The more products you produce, the more you gain an immediate scale advantage, because the fixed costs associated with each unit go down automatically.

Think about widgets for a moment. Suppose that you rent a building at $1,000 a month to house widget production. So as not to lose money, you have to add that rental expense into the cost of the widgets that you make. Perhaps the first month, you turn out only ten widgets. No matter what else they cost, you have to add $100 rent ($1,000 divided by ten units) to the price of each widget. But if you can boost production to 100 units the next month, you have to add only $10 in rent ($1,000 divided by 100 units) to the price of each widget, and you reduce your rental costs per unit by a whopping 90 per cent. Scale is good for business and your bottom line.

- **Scope:** *Scope* works a little like the scale effect, but scope refers to the underlying cost benefit that you get by serving larger markets or by offering multiple products that share overhead expenses associated with such things as advertising, product service and distribution. (Chapter 14 provides more information on juggling your product expenses.) These expenses aren't exactly fixed, but you do gain an automatic scope advantage if the ad that you decide to run reaches a larger market or if your delivery trucks deliver two or three products to each of your sales outlets instead of one.

- **Learning:** Remember the first time you tried to tie your shoelaces? Big job. A lot of work. Now you can do it in your sleep. What happened? The more you tied your shoes, the better you got at it. The same is true whether you're on a factory floor, at a computer workstation or in a conference room. You (and your employees) get better at something the more you do it. As you learn, the overall cost of doing business goes down.

A general rule suggests that all these underlying causes result in what's known as an 80 per cent experience curve. Every time you double the total number of products produced, unit costs go down by about 20 per cent – to 80 per cent of what they were before.

The cost benefit that you actually get out of your own company's experience is bound to vary and depends partly on your industry. A few industries don't benefit from experience effects at all. In industries in which the basic costs of raw materials are high, for example, you won't have much room for gaining a big advantage through experience. Many service industries may not get much of an advantage from experience, either. It doesn't matter how good hairstylists become at what they do; it still takes them about an hour to wash and style each customer's hair, so the company's costs don't change.

Low-cost culture

You can sustain low-cost leadership only if every part of your company is committed to keeping costs under control, reducing or eliminating expenses and unnecessary spending. This kind of commitment doesn't occur without leadership and the example set by the owners themselves.

Perhaps more than any other strategy and business plan that you can pursue, the push to be the low-cost leader in your industry succeeds or fails based on how well you actually carry it out. Knowing where and when to bring in cost-saving technology may be one important aspect of your drive, for example. But at the heart of your plan, you absolutely must figure out how to structure the company, reward your employees and create the spirit of a ‘lean, mean fighting machine’. In the end, your employees determine just how efficient your company really is. This situation may mean that you don’t drive a company car or that you never, ever make personal long-distance calls from work. You can bet that your employees follow your lead.

Low-cost leadership means exactly what it says. It’s just not good enough to be first, second or third runner-up; it’s not even all right to be first among equals. If you can’t assume the cost-leadership position, you run the risk of playing a part in your own worst nightmare: a high-stakes, cut-throat industry in which price-war shoot-’em-outs threaten to destroy all the players. After all, if no one’s a clear leader, everyone’s a challenger, and when low-cost challengers decide to battle for market-share advantage, they use price as their favourite weapon. If you happen to find yourself in such a Wild West industry, take action. Look for new and different ways to compete – alternative strategies that are more likely to reward you in the end.

Standing out in a crowd

Not every company can be the low-cost leader in an industry, and many companies don't even want to be. Instead, they prefer to compete in the marketplace by creating products and services that are unique, offering customers things that they just have to have – things that they're willing to pay a little extra for. The strategy is known as *differentiation*.

Differentiation has a great deal going for it, because companies can be different in many ways, which means that you've many ways to be successful. Although the low-cost strategy that we talked about in the preceding sections can easily produce a win-lose situation for many companies, differentiation often creates room for more players, each of which competes successfully in its own special ways. That's not to say that competition isn't fierce, even when companies offer distinctly different products or services.

Companies that can make themselves distinct from their competitors often enjoy enviable profits, and they frequently use those extra pounds to reinforce their unique positions in the marketplace. A premium winery, for example, earns its reputation based on the quality of grapes and expertise of the winemaker, but it goes on to polish that reputation through expensive packaging and promotional campaigns. All these added investments make it more difficult for competitors to join in, but they also raise the cost of doing business. Although a maker of house wine has trouble competing in premium markets, a premium winery really can't afford to compete on price alone. No company can ignore cost, of course, even if it offers something that no one else does. Wine-lovers may be willing to spend £15 for a special bottle of chardonnay but may baulk at a £30 price tag.

Chances are that you can make your company unique in a number of ways. You can set your product or service apart based on what it can do, how well it works or the way that it is packaged and distributed. Then you can go on to develop any of these aspects into a successful differentiation strategy, creating a loyal set of customers along the way.

AHEAD OF THE PACK

Because a differentiation strategy hinges completely on your relationship with customers, however, stop and ask yourself several questions before you move ahead:

- Who are your customers?
- How would you best describe them?
- What are their basic wants and needs?
- How do they make choices?
- What motivates them to buy things?

Check out Chapters 5 and 6 for insight on customers. The following sections describe ways that you can set yourself apart from the competition.

Product features

You can often find the basic outlines of a successful differentiation strategy in what your product can and can't do for customers. After all, a product's features are frequently among the first things that a potential buyer considers. How do your products stack up? Are you particularly strong in product design and development? (Chapter 9 may help you decide whether you are.) If so, you probably want to consider how to leverage your strength in developing new features to make your company's product stand out.

Unfortunately, product features represent a big target for your competitors to aim at, and trying to be different based on major product attributes alone is sometimes hard to sustain over the long haul. Technology-driven companies such as Sony, 3M and Intel have managed to stay one step ahead of the competition for many years by always offering the latest and greatest products. But you won't find it easy (or inexpensive) to be chased all the time.

Rather than always take the lead in product development, you can make your company stand out by enhancing a product in more subtle ways, offering customers unique and tailored options that are appreciated all the more because they're often unexpected. Examples include a camera that senses when you've forgotten to put the film in, an insurance policy that makes it easy to keep track of what you own and then automatically updates your coverage and software that actually helps you remove every bit of itself from your hard drive when you want to get rid of it.

Product quality

When you offer a product or service that's known for its quality, you take a big step toward standing out in the marketplace. In some sense, quality captures what differentiation is all about. Quality of one sort or another is what everybody seems to be looking for, and quality is often in the eyes of the beholder. Although customers can't always tell you exactly what quality is, they know it when they see it, and when they see it, they like it – and may even pay a little extra for it.

Customers are likely to perceive quality in your product a bit differently than they do quality in a service that you may offer. The differences between product and service quality are big enough, in fact, that we treat the two separately in Table 13-1.

Table 13-1 Product and Service Quality Examples

Product Quality	Example
Performance	Do pots and pans get clean in the dishwasher?
Consistency	Is the restaurant's pasta special always tasty?
Durability	How long will the hiking boots last?
Reliability	Will the answering machine save all the messages?
Appearance	Does the watch have that special look and feel?
Brand name	Which stereo system is known for its quality?
Service quality	**Example**
Capability	Does the brain surgeon know what she's doing?
Dependability	Will the newspaper be delivered in the morning?
Responsiveness	Can the 999 emergency team arrive in time?
Integrity	How much should the lawyer be trusted?
Attentiveness	Does the bank clerk smile and say hello?
Tangibles	Which airline has the cleanest onboard toilets?

The different quality dimensions depend on the industry that you're in and on the customers you're serving. Even in a particular industry, companies create successful differentiation strategies for distinct dimensions. The car industry is a prime example. When you think of Porsche, for example, you think of performance; Volvo means safety; and Toyota and Honda are reliable choices. These differences allow competitors to prosper in the same industry, each in its own way.

Things are a bit different in service industries. For one thing, you can't help but face the importance of customers' impressions when you're dealing with services. By definition, a service is something that can't be held; you can't really touch it, feel it or kick its tyres. So customers are in a bit of a quandary when it comes to making well-informed decisions. Figuring out what is and isn't a quality service is harder. How do you really know whether your doctor's a genius or a quack, for example? Is the pilot of today's flight an ace or just so-so? Is your dentist a saint or a sadist?

That's why perceptions come into play. When customers don't have all the data, they go with what they see. No matter what other dimensions are important, the tangibles – equipment, facilities and personnel – play a significant part in customers' perceptions of service quality. As an airline executive said:

> *Filthy toilets and dirty trays are bound to lead to engine failure.*

Because customers have no way of evaluating the quality of an airline's engine-maintenance programme, they look at the things that they *can* judge, and they form their opinions accordingly.

Product packaging

Customers often look beyond the basics in making the final decision on what to buy. In fact, your customers may be influenced as much by the packaging as by the standard set of features that your product or service has to offer. Accordingly, you can develop an effective differentiation strategy based on product packaging – how it's advertised, when it's serviced and where it's sold.

Given creative advertising, attentive service and sophisticated distribution, almost anything can be made unique in one way or another. If you don't believe us, check out the produce section in a classy supermarket. Fruit and vegetables are routinely identified by country, state or even farm of origin. Signs tell customers whether the produce was grown with or without chemicals and even specify the harvest date. Each combination represents a differentiated product to be advertised, displayed and priced based on the unique benefits that it offers.

It's all in the packaging

- Calvin Klein underwear costs more than the Jockey brand, but Calvin Klein boxers and briefs are big sellers because they capture the imagination of men who want to look like Calvin Klein models in nothing but their undies.

- Avon products look a great deal like cosmetics that you can buy almost anywhere, but the Avon Lady still gets the attention of women across the country who want to be pampered on their own sofas with their favourite skin-care products.

- Local gift shops may not offer the lowest prices, but by serving up homemade cakes and jams when you come in the door, they provide a unique shopping experience that keeps many customers coming back.

A special kind of Cat

Caterpillar, Inc. is the giant company that builds those giant yellow machines that build motorways, bridges, dams and airports around the globe. Caterpillar makes some of the best heavy-construction machines in the world, but its customers are impressed by much more than just equipment specs. What really sets this company apart is its unmatched capability to deliver service and spare parts at short notice. Caterpillar makes this commitment to each of its customers: no matter where you are in the world, no matter what replacement part you need, they'll see that you have it to hand within 24 hours.

This promise is a big and expensive one. Caterpillar has spent a fortune creating a global service network with distribution depots that can fulfil its pledge, which of course means higher prices for Cat equipment. But customers don't mind paying those extra pounds, because they know how much they stand to lose if they have to shut down huge construction projects for want of a spark plug or fan belt. So Caterpillar sells peace of mind along with its machinery.

Focusing on focus

JARGON ALERT

The two generic strategies that we've talked about so far concentrate on one side of the customer value equation or the other. A cost-leadership strategy points out the price tag, whereas differentiation emphasises the unique benefits that a product or service has to offer. The final generic strategy plays off the first two strategies. A *focus strategy* still aims at price or uniqueness, but it concentrates on a smaller piece of the action.

A focus strategy works because you concentrate on a specific customer group. As a result, you do a better job of meeting those customers' particular needs than do any of your competition, many of whom are trying to serve larger markets. The following sections discuss several ways to concentrate your efforts.

Niche markets

Small, well-defined market segments provide an opportunity not only to meet customers' needs, but also to exceed their expectations. If these market segments happen to be at the high end, you're likely to be well rewarded for your attentions as the money keeps rolling in. Small, upmarket hotels, for example, pamper their well-heeled customers with valets, butlers and even a chauffeured service to restaurants and the airport. A new breed of takeaway food services treats customers to mix-and-match offerings from the best restaurants in town, well-dressed delivery people and even sit-down catering complete with china, crystal and kitchen staff.

Customers are willing to pay a premium for this kind of service, and that means big profits. Niche markets don't have to be upmarket, of course; factory outlet stores are thriving by serving cost-conscious customers who have high-end tastes.

Targeted products

Companies that are driven by volume sales in large markets often ignore so-called speciality products and services – all those non-standard items and services that have limited appeal and not much market potential. If these companies do get into a speciality business, they're usually fairly inefficient at it; size and overhead costs simply work against them. Speciality products and services spell potential opportunity for a focused strategy to be successful.

EXAMPLE

Speciality hardware manufacturers, for example, have found a ready market for their new lines of old hardware. As it turns out, antique screws, hinges, doorknobs and hundreds of other hard-to-find items are absolute necessities for turning run-down terraced houses back into elegant period dwellings.

Limited territory

Sometimes, a focus on geography results in cost advantages, better-served markets, or both. Where local tastes are strong, for example, or service and distribution costs are particularly high, a regional business can flourish. Independent restaurants and grocery shops, TV stations and newspapers all attract a community of customers who want local news, buy regional products and like to patronise neighbourhood shops. Commuter airlines focus on regional service, offering frequent flights and the best schedules to out-of-the-way destinations, and they keep costs down by flying smaller planes, limiting facilities and running bare-bones operations.

A focus strategy works especially well if you're the new kid on the block, trying to establish a foothold in an industry in which the big guys have already staked out their claims. Rather than go after those fat, juicy markets (and get beaten up right away), you can sometimes avoid head-on competition by focusing on smaller markets, which may be less attractive to existing players. Once you're established in a niche market, you may decide that the time is right to challenge the market leaders on their own turf. Morrisons, the supermarket chain, for example, started out as a small local chain offering bargain prices and a limited range. The company became a major regional player, and with its acquisition of Safeways, is now the third most successful supermarket nationally.

For small established companies in a market, a focus strategy may be the only ticket to survival when the big guys decide to come to town. If your company has few assets and limited options, concentration on a specific customer segment at least gives you a fighting chance to leverage the capabilities and resources that you do have.

Customer loyalty can prove to be a potent weapon, even against much larger companies. Major Multiples, for example, finds moving their superstores into small rural towns to be increasingly difficult, because the neighbours rally around local businesses and merchants that have made them satisfied customers over the years, despite the fact that Multiples probably have a wider selection of products at lower prices.

Unfortunately, a focus strategy is one of the most difficult to defend over time. Dangers lurk both inside and outside the company. If the market segment that you're in suddenly takes off, you can pretty much count on intense competition down the road from much bigger players with much deeper pockets.

If your market niche stays small, you face a powerful urge to spread your wings and expand into new and different markets, knowing full well that you may lose many of your original strengths and advantages. Your best bet is to stay focused. Small companies have the best chance of sticking around over the long haul if they stick to a strategy and business plan that concentrate their resources and capabilities, focusing their energies on serving a specific market segment better than anyone else out there.

Be sure to keep these points in mind:

- Planning pundits highlight three generic strategies that can jump start your planning efforts: cutting costs, offering unique products or services and focusing on one customer group.

- To be a low-cost leader, track down and exterminate unnecessary costs.
- To set your company apart, offer something new and different – faster, stronger, tastier, longer-lasting or more reliable.
- To adopt a focus strategy, zero in on a specific group of customers, and serve them better than anyone else does.

Checking Out Strategic Alternatives

A successful strategy and plan depend on your business circumstances – what's happening in the industry and marketplace, and what your competitors are up to. In particular, consider a couple of common business situations that you may find yourself in.

Going up, down, or sideways

The range of activities that define your industry – called *vertical integration* – measures how many phases of the business you and your competitors are involved in. Vertically integrated companies are involved in many parts of an industry, from supplying raw materials to selling products and services to customers. Companies that are not vertically integrated tend to focus on one or two major aspects of the business. Some breweries, for example, concentrate on one central activity: the brewing of beer.

Other breweries also get involved in growing the barley and hops; in making the beer bottles, labels and cans; in trucking the beer around; and even in running the pubs that sell the beer to all those loyal customers.

Exactly where does your company stand in terms of vertical integration in your own industry? The question's important, because it affects your decision about whether to become more or less vertically integrated over time. Several terms have been coined by business gurus to describe the strategic moves that you may decide to make:

- **Backward integration:** *Backward integration* means extending your business activities in a direction that gets you closer to the raw materials, resources and expertise that go into creating and producing your company's products.
- **Forward integration:** *Forward integration* means extending your business activities in a direction that gets you closer to the marketplace by involving the company in packaging, marketing, distribution and customer sales.
- **Outsourcing:** *Outsourcing* means concentrating on your core business activities by farming out other parts of your company's operations to outside contractors and vendors that specialise in those particular areas.
- **Divesting:** *Divesting* means reducing your company's activities to focus on specific aspects of your business by spinning off or selling other pieces of the company.

Tables 13-2 and 13-3 describe some of the pros and cons of vertical integration.

Table 13-2 Pros of Vertical Integration

Pro	Reason
Efficiencies	If you're in charge, you sometimes find it easier to coordinate activities at the various business stages along the way, combining related functions or getting rid of overlapping areas to streamline your overall operations.
Resources	If you've a hand in the upstream (early-stage) activities of a business, you can guarantee that your company has access to the raw materials and resources that it needs to stay in business.
Customers	If your company is involved in downstream (late-stage) activities, you not only get to know a great deal about customers, but also create lasting relationships and secure your own long-term access to the market.

Table 13-3 Cons of Vertical Integration

Con	Reason
Overhead	If your company tries to control all stages of its industry, it can run into all sorts of extra expenses because of mismatched operations, idle resources and added coordination costs.
Mediocrity	If your company is involved in a wide range of activities, you find it much tougher to be the best at any of them, and the company risks becoming average in everything that it does.
Size and slowness	If your company is vertically integrated, its size often makes it difficult to quickly respond to change, and commitments to various parts of the industry leave it little room to be flexible.

You have both good news and bad news in terms of deciding just how much vertical integration is best. Over the years, there have been swings in the popularity of vertically integrated companies: A rush toward control of all aspects of an industry is followed by the race to break up companies and concentrate on specific business activities. Then the cycle repeats itself.

Today's wisdom seems to come down on the side of breaking companies apart. Worldwide competition in all industries over the past decade has made it more cost-effective to go out and buy what you need rather than to try to build up resources and expertise inside the company. That practice has resulted in a wave of downsizing and restructuring as companies struggle to remain competitive at what they do best.

And the future? One thing seems to hold true across the swings and cycles: the most successful and profitable businesses most often do business at one of the two extremes of integration. Companies that are heavily integrated reap all the real benefits of vertical integration; those that concentrate on a single activity eliminate all the costs and inefficiencies. Whatever you do, try not to get stuck in the middle, with few of the benefits and too many of the costs.

Leading and following

No matter what industry you're in, you can divide your competition into two major groups: the market leaders and all the market followers nipping at their heels. *Market leaders* are those top-tier companies that set the agenda for the industry and make things happen; they're the ones in the driver's seat. The *market followers,* well, they follow along. But in this second group, you find the companies that work hard, think big and keep the market leaders on their toes.

Depending on the market situation, companies in both groups behave very differently. Whether you're already a part of an industry or are thinking of joining it as a new business owner, make sure that you understand what motivates both the market leaders and the rest of the pack. The following sections explore some market strategies.

Market-leader strategies

Market leadership comes in various forms, from the absolute dominance of one company to shared control of the industry by several leading players. If you're a market leader, here are some possible strategic approaches for you:

- **Full speed ahead:** In this situation, your company is the clear market leader. Even so, you always try to break further away from the pack. You're always the first to make a move, whether in implementing new technology and introducing innovative products or in promoting new uses and setting aggressively low prices. You not only intend to stay on top, but also want to expand your lead.
- **Hold the line:** Your company's certainly in the top tier in the market, but it doesn't have a commanding position of strength in the industry, so your goals centre on hanging on to what you've already got. Those goals may involve locking distributors into long-term contracts, making it more difficult for customers to switch to competing brands or going after new market segments and product areas to block competitors from doing the same thing.
- **Steady as she goes:** In this case, your company is one of several powerful companies in the market. As one among equals, your company takes on part of the responsibility of policing the industry to see that nothing upsets the boat. If an upstart challenger tries to cut prices, for example, you're there to quickly match those lower prices. You're always scanning the horizon for new competitors, and you work hard to discourage distributors, vendors and retailers from adding new companies and brands to their lists.

Market-follower strategies

Market followers are often forced to take their cues and develop strategies based on the strength and behaviour of the market leaders. An aggressive challenger, for example, may not do well in an industry that has a powerful, assertive company on top. Fortunately, you can choose among several strategic alternatives if you find yourself in a market-follower position:

- **Make some waves.** In this case, your company has every intention of growing bigger by increasing its presence in the industry, and you're quite willing to challenge the market leadership head-on to do it. Perhaps your strategy includes an aggressive price-cutting campaign to gain as much market share as you can. Maybe you back up this campaign with a rapid expansion of distribution outlets and a forceful marketing effort. The strategy requires deep pockets, will and the skill to force a market leader to blink, but in the end, it could make you the leader of the pack.

- **Turn a few heads.** In this situation, your company is certainly not one of the market leaders, but successful in its own market niche, and you want it to stay that way. So although you're careful not to challenge the market leadership directly, you're fierce about defending your turf. You've strengths and advantages in your own market segment because of the uniqueness of your product and customer loyalty. To maintain this position, you focus on customer benefits and the value that you bring to the market.

- **Just tag along.** It's easy to point out companies that have settled into complacency. Frankly, they're usually in rather boring industries in which not much ever happens. These companies are quite happy to remain toward the end of the pack, tagging along without a worry. Don't count on them to do anything new or different in the marketplace. (If you find yourself in a company like this, you may want to think about making a change while you're still awake.)

Remember the following when checking out strategic alternatives:

- A successful strategy must take into account what your competitors are up to.
- Vertically integrated companies control many aspects of their business and can streamline their operations.
- Companies that concentrate on one or two activities are more flexible and can focus on what they do best.
- Market leaders set the agenda for the industry and shape the competitive landscape.
- Market followers aren't in the driver's seat, but they work hard, think big and sometimes become leaders of the pack.

Looking at the Marketing Mix

The building blocks in a marketing strategy are:

- Your **P**roducts and services
- The **P**rice you charge
- The way you **P**romote, advertise and sell
- The way you get your offer to market – retail, wholesale, internet and so forth – the area shortened in strategic speak to the single word **P**lace.

The way in which these different elements are used to create a strategy is known in the trade as the *marketing mix*. The subject has a pedigree going back to the late 1940s when marketing managers referred to mixing ingredients to create strategies and the concept was formalised by E. Jerome McCarthy, a marketing professor at Michigan State University in 1960. A fifth P, **P**eople, is often added. Just as with cooking, taking the same or similar ingredients in different proportions can result in very different products. A change in the way these elements are put together can produce an offering tailored to meet the needs of a specific market *segment.*

The ingredients in the marketing mix only represent the elements that are largely, though not entirely, within a business's control. Uncontrollable ingredients include the state of the economy, changes in legislation, new and powerful market entrants and rapid changes in technology. (Refer to chapter 12 where we tackle these ingredients.)

Change any element of the marketing mix, or any combination and you've a brand new strategy.

> This book you're reading is a good example of a product of a business sector subject to many different strategies being used to penetrate different market segments. At the most basic level, books used to be produced in two generic forms – hardback and paperback. The actual text was identical in each version. However, the hardback was usual brought out first, priced higher and seen as premium product aimed at the fashion-conscious reader.

E-versions have now appeared aimed at yet another market segment. The distribution channels – the *place* element of the marketing mix – have developed too. Now you can still buy books in shops, but also online, and you can even get them produced to order. The content of many books can be sliced and diced for different markets too. The idea isn't that new. Dickens, Collins and many earlier authors started out serialising their books. Now chapters of books are sold, or given away as 'appetisers' to stimulate interest.

Coming Up with Your Own Strategy

If you feel a bit overwhelmed by all the possibilities for devising a strategy for your own company, stop and take a deep breath. Remember one important thing: strategy isn't a test that you take once and have to get a perfect score on the first time. Instead, strategy is the way that you decide to do business over the long haul. Strategy is an ongoing process, so don't be alarmed if you can't see how all the pieces fit together all at once.

Coming up with the right strategy is something that you've the chance to work on over and over again – rethinking, revising, reformulating. If you approach strategy in the right way, you probably won't ever finish the task.

As you begin to shape your own strategy, the following pointers can guide you:

- Never develop a strategy without first doing your homework.
- Always have a clear set of goals and objectives in front of you.

- Remember what assumptions you make, and make sure that they hold up.
- Build in flexibility, and always have an alternative.
- Understand the needs, desires and nature of your customers.
- Know your competitors, and don't underestimate them.
- Leverage your strengths and minimise your weaknesses.
- Emphasise core competence to sustain a competitive advantage.
- Make your strategy clear, concise, consistent and attainable.
- Trumpet the strategy so that you don't leave the organisation guessing.

These guidelines are not only helpful for creating a strategy, but also useful for reviewing and revising one as well. Make sure that you return to them on a regular basis as part of your ongoing commitment to the strategy and planning process.

Companies that take strategy and business planning seriously know that to reach a target, it's 'ready, aim, fire' – not 'ready, fire, aim'. It's that simple. In other words, almost any strategy is better than no strategy at all. Companies that have clear strategies don't hit the bull's-eye every time; no strategy can promise that. But these companies succeed in the end because they subscribe to a strategic process that forces them to ask the right questions and come up with good answers – answers that are often better than their competitors' answers.

Chapter 14

Managing More than One Product

In This Chapter

- Working with the product life cycle
- Expanding your market
- Extending your product line
- Diversifying into new businesses
- Identifying strategic business units
- Managing your product portfolio

Watching over a product or service as it makes its way through the cold, cruel marketplace is an awesome responsibility. It requires a major commitment of time and resources, as well as a great deal of careful planning. First, you have to understand what's required for the product to be successful. Which attributes and aspects should you stress? How do you make sure that people take notice (and like what they see)? What must you do to support and guide your product or service along the way, getting it into the right hands? You want to take advantage of opportunities as they appear. At the same time, you have to worry about the threats and competitive pressures that are lurking out there.

Does this sound a lot like rearing a child? Well, your product's your baby, and as any parent can tell you, you're going to have one blessed thing after another. Think how many times you've heard a parent say, 'You think they're difficult now? Just wait!'

Products and kids have a great deal in common; both of their worlds are continually changing, yet they eventually manage to grow up. For decades, the Dr Spocks of the business world have poked, probed, pinched and studied products at all ages, and they've come up with a useful description of the common stages that almost all products go through. When you create a business plan, you have to plan for the changes in your own product's life cycle.

In this chapter, we explain the product life cycle and what it means for your company. We talk about ways to keep your company growing. We show you how to expand into new markets with existing products, as well as how to extend your product line to better serve current customers. We explore the opportunities and pitfalls of trying to diversify. We talk about strategic business units (SBUs) and introduce several portfolio tools to help you plan and manage a family of products.

Facing the Product/Service Life Cycle

If you could use only one word to describe what it feels like to be in business and to compete in a marketplace, that word probably would be *change*. The forces of change are everywhere, ranging from major trends in your business environment to the shifting tastes and demands of your customers and the unpredictable behaviour of your competitors.

You may think that all these factors, stirred together, create a world filled with chaos and uncertainty. Not so. The experts have stumbled onto some basic patterns, and the cycles that they've created do a good job of describing what happens in the face of all the market turmoil and confusion.

One of these patterns – the *product life cycle* – illustrates what happens to a new kind of product or service after you launch it in the market. The product life cycle describes four major stages that your product is likely to go through:

- An introduction period
- A growth period
- Maturity
- A period of decline

Most product life cycles look something like Figure 14-1.

The curve traces your product sales volume over time. You can think about the sales volume in terms of the revenue that you take in or the number of units that you sell, and you may end up measuring the time scale in weeks, months, years or even decades.

Every stage of your product's life cycle presents a unique set of market conditions and a series of planning challenges. The different stages require different management objectives, strategies and skills. The following sections discuss what you should think about at each stage.

Starting out

You introduce a new kind of product or service in the market, and it begins to generate revenue. Because costs are relatively high at this stage, you usually don't find too many competitors around. Growth is limited instead by your company's ability to make the product, generate market awareness and get customers to accept and adopt the new product.

At this stage in the product life cycle, efforts focus on getting your product out the door or on rolling out the new service and ensuring that everything works the way that it's supposed to. At the same time, you have to drum up lots of interest and struggle to create a brand-new market. Table 14-1 points out many characteristics of the introduction stage.

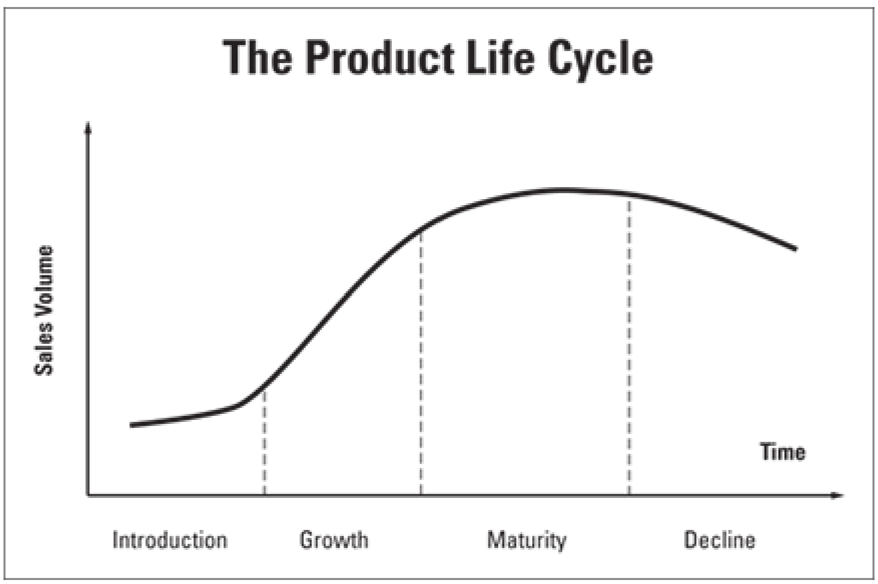


Figure 14-1: The product life cycle represents what's likely to happen to sales volume for a typical product or service over time.

Table 14-1 Major Characteristics of the Introduction Stage

Component	Characteristics
Industry	One or two companies
Competition	Little or none
Key function	Research and development
Customers	Innovators and risk-takers
Finances	High prices and expenses
Profits	Non-existent to negative
Objectives	Product adoption

Strategy	Expanding the total market

Growing up

Your new product or service gains a reputation during the growth stage. Demand rises rapidly, and sales increase. Competition increases as well, as competing products jump into the fray to take advantage of an expanding market. Customers begin to develop brand loyalties, and companies tweak their product features to better serve customer needs – needs that are now easier to recognise.

As the growth stage kicks in, your priorities turn toward meeting growing product demand, improving your product or service and targeting specific groups of customers. Along the way, you have to fend off a growing crop of competitors. Table 14-2 highlights characteristics of the growth stage.

Table 14-2 Major Characteristics of the Growth Stage

Component	Characteristics
Industry	Many companies
Competition	Growing strength and numbers
Key function	Marketing
Customers	Eager to try products
Finances	Variable prices and costs
Profits	Growing rapidly
Objectives	Sales growth and market share
Strategy	Establishing and defending position

Coping with middle age

The growth of your product or service begins to slow in the maturity stage, as market demand levels off and new customers become harder to find. New competitors are also harder to find, and the competition stabilises. Profits keep on growing, however, as costs continue to fall. Changes in market share reflect changes in product value and often come at the expense of competing products.

As maturity sets in, your attention turns toward reducing costs and finally reaping the benefits of stable profits. Although you may well feel comfortable at this stage, you need to think about what's going to happen next. Table 14-3 identifies the characteristics of the maturity stage.

Table 14-3 Major Characteristics of the Maturity Stage

Component	Characteristics
Industry	Not as many companies
Competition	Stronger, but stable
Key function	Operations
Customers	The majority of buyers
Finances	Competitive prices and lower costs
Profits	At or near peak
Objectives	Cash flow and profit
Strategy	Maintaining competitive position

Facing the senior stretch

At some point in your product's life cycle, sales start to fall off and revenue begins to decline. Competitors drop out of the market as profits all but disappear. The decline stage may be triggered by large-scale changes in the economy or technology, or it may simply reflect changing customer needs and behaviour. Products still on the market in this stage are redesigned, repositioned or replaced.

As the decline stage looms, you have to get back into the business trenches. Your work shifts to redesigning your product or redefining its market, or maybe coming up with new uses or different kinds of customers. If all these attempts fail, you have to concentrate on ways to get out of the market and not lose too much money. Table 14-4 shows various characteristics of the decline stage.

Table 14-4 Major Characteristics of the Decline Stage

Component	Characteristics
Industry	Few companies
Competition	Declining in number
Key function	Finance and planning
Customers	Loyal, conservative buyers
Finances	Falling prices and low costs
Profits	Much reduced
Objectives	Residual profits
Strategy	Getting out alive

Judging where you are now

AHEAD OF THE PACK

Take your own product or service and see whether you can come up with its estimated position on the product life cycle curve (refer to Figure 14-1 earlier in this chapter). If you're stumped, ask yourself the following kinds of questions:

- How long has the product been on the market?

- How rapidly is the market growing?
- Is the growth rate increasing, decreasing or flat?
- Is the product profitable?
- Are profits heading up or down?
- How many competitors does the product have?
- How fast are product features changing?
- Are there more or fewer competing products than there were a year ago?

Perhaps you feel confident about where your product is in its life cycle. That’s good. Just make sure, though, that you take the time to confirm your analysis. Chances are that you’re going to get mixed signals from the marketplace, and the clues may even contradict one another. No two products ever behave the same way when it comes to the product life cycle. Unfortunately, acting prematurely on the evidence at hand can lead to hasty planning and a self-fulfilling prophecy.

Suppose that the widget manager at Global Gizmos Company detects a slowdown in widget sales. As a faithful believer in the absolute law of the product life cycle, she comes to the obvious conclusion that the growth stage for widgets is finally coming to an end. What does she do? For one thing, she begins to think about ways to reduce costs. Maybe she cuts the advertising budget and begins to phase out incentives for the sales force. What happens? Sales of widgets decline even further, just as she predicted. So she pats herself on the back for being the first to recognise the early stages of a worldwide widget decline.

But what if the sales slump is actually reversible, simply caused by a bit of bad weather, some delivery problems or any number of other reasons? By substituting blind faith in a business textbook for her own good judgement and careful analysis, the widget manager actually caused the outcome that she so confidently predicted in the first place.

What good is a business concept if you can't really count on it? Well, don't get us wrong here. The product life cycle is a powerful planning tool if you use it to support – not replace – your own solid skills. When deployed as an early warning system, the product life cycle alerts you to potential changes, allowing you time to plan for a different business environment and to respond quickly when your product finally enters a new stage in its life cycle.

A few things to remember when thinking about the product/service life cycle:

- Your product or service goes through a life cycle that includes introduction, growth, maturity and (alas) decline.
- When you introduce a new kind of product, costs are high, but competitors are few.
- During your product's growth stage, demand increases fast, but so does competition.
- At maturity, competition stabilises, and as your costs continue to decline, profits grow.
- When decline sets in (as new technologies come along or customers' habits change), sales, revenue and profits head south.

Milking cash cows

Products in decline are not all bad news. Often at that stage the full costs of developing and launching them have been recovered, they no longer warrant much advertising or support and as a consequence are major cash generators. By contrast, new products need bags of cash, so why not marry them up. Cash cows, as products in decline can be, can be used to support tomorrow's stars.

See more on this process later in this chapter when we cover the Boston Consulting Group's Growth Share Grid.

Finding Ways to Grow

Face it – your product simply isn't going to be the same tomorrow as it is today. You may not plan to do anything to it at all, but everything around your product is going to change. The world will take another step ahead. The economy, technology, your industry and the competition will all change a bit. As a result, your customers will think about your company and your product a bit differently, even if you see yourself as being exactly the same.

How does your company find ways to grow and prosper in the face of almost-certain product mortality? You probably have every intention of creating a new business plan (beyond turning off the lights and locking all the doors) as your product begins to age. But which way do you turn? Mark Twain had a bit of tongue-in-cheek advice for people who prefer to keep things just as they are:

Put all your eggs in one basket . . . and watch that basket!

Trouble is, the eggs are going to hatch, and the chicks will probably run away. So doing nothing except watching and waiting is not really an option. But what are your alternatives?

Fortunately, you don't have to invent the alternatives yourself; planning for long-term growth has been a philosophical favourite of management gurus for decades. One of the pioneers of business-growth techniques was a man named Igor Ansoff, who came up with a simple matrix to represent the possible directions of growth (see Figure 14-2).

Figure 14-2: The Growth Directions Matrix describes different ways in which your company can grow, based on a combination of products and markets.

The Growth Directions Matrix really captures nothing more than basic common sense: it says that if you want to make your business grow, you have to start somewhere. The logical place to begin is to take advantage of where you are today and what you have to work with. How fast you grow in any of these directions has everything to do with your own capabilities and resources, as well as the rate of change in your industry. Consider the following ways in which you can move your company ahead:

- **You are here (existing product and market):** Continue to grow by doing what you're already doing, but do it a little bit better, so that customers use more of your product or service more often and in more ways than before. Encourage people to use more toothpaste, for example, by brushing their teeth (or even their dog's teeth) more often.
- **New market, existing product:** Grow in the near term by finding a fresh market for your existing product, by expanding geographically or by reaching out to completely different kinds of customers. If you make baking soda, for example, get people to put baking soda in their refrigerators to keep them odour-free.

- **New product, existing market:** Grow by developing additional product features, options or even a related product family with the intention of enticing your existing customers. Think of the array of apple drinks that are available these days – everything from Appletize to apple-flavoured water.
- **New market, new product:** Grow over the long term by going after new and unfamiliar markets with new and different products. Ford Motor Company, for example, used to make and sell prefabricated homes.

Without getting bogged down in a lot of details, try to come up with a dozen different ways to grow your company. Get yourself into the right frame of mind by first reviewing your company's mission and vision statements. (Don't have 'em? Flip to Chapters 2 and 3 for everything that you need to know.) Then complete the following steps:

1. **Identify three things that you can do right away to stimulate demand for your existing product in your current markets.**

   These things may include cutting costs, offering rebates or maybe coming up with some new product uses.

2. **List three steps that you can take in the next six months to capture new markets for your existing product.**

   Some ideas include radio or television ads that target new customers, direct-mail campaigns and stepped-up appearances at trade shows.

3. **Specify three development efforts that you can launch over the coming year to extend your current product line.**

   These efforts may include enhancing product features or adding options.

4. Describe three directions that you can take over the next three to five years that can move you into new products and markets.

More than one or two experts believe that any talk about brand-new products for completely new markets is really none of your business as a manager. These financial gurus think that managers are simply too biased to be objective when it comes to assessing totally new opportunities. They argue that you should return all your extra profits to investors and let them decide where to place their bets on the future. You probably don't agree with them; after all, investors have made monumental mistakes in the past. But they do have a good point. Remember that growth in new directions is a tricky business, no matter how it's done or who ends up doing it.

Same product/service, same market

Many successful big-name companies have become as big and successful as they are by relentlessly pursing a single business, a single market, or even an individual product decade after decade. When you hear the name Timex, for example, you think of a watch . When you see a Coca-Cola sign, you imagine drinking a Coke. And when you pass a McDonald's, you probably picture a Big Mac. But these companies haven't turned into billion-pound corporations simply by launching their flagship products and letting the marketplace take care of the rest. Companies that largely depend on a single product spend enormous amounts of time and effort to continually rejuvenate and revitalise their core markets.

If you glance back at the Growth Directions Matrix shown in Figure 14-2 earlier in this chapter, you notice that these companies invest heavily in the top-left box. How do they manage to do that successfully? They use the four main strategies described in the following sections:

- **Encourage greater product use.** A company increases demand by encouraging its customers to consume more of a product or service every time they use it. Maybe that means getting customers to feel good about buying more or giving them a better deal when they do. Customers may do the following things:
  - Buy larger bottles of cola because they can save money.
  - Apply for more insurance coverage because you carefully show them that it's the prudent thing to do.
  - Stay on the phone longer because the rates are lower.

- Opt for a packaged computer or stereo system with all the components because of easy assembly.

- **Generate more-frequent product use.** A company stimulates sales by getting customers to use its product or service more often. That may mean making the product more convenient, introducing it as part of customers' regular routine or offering incentives to frequent customers. Customers may do the following things:
  - Use toothpaste after every meal because they think that it's hygienic.
  - Regularly drink wine at dinner because they think that it's healthy.
  - Join a frequent-flyer programme and take an extra trip just to build more miles.
- **Devise new uses.** A company expands its market by coming up with new ways for customers to use its product or service. That may include getting customers to use the product at different times, in different places, on novel occasions or in unconventional ways. All of a sudden, customers may do the following things:
  - Snack on breakfast cereal during the day because it's handy and tastes good.
  - Put a radio in the shower and a TV in the car because they're convenient.
  - Make videos of every imaginable event from childbirth to pet funerals.
- **Woo customers away from competitors.** A company can also increase demand for its product or service the old-fashioned way: by taking customers away from the competition. Although the result is sometimes a fierce

and unwanted response from competitors, companies can do the following things:

- Create incentives to switch from competing products and give rewards for staying put.
- Concentrate on becoming a low-cost provider with the best prices around.
- Package a product so that it's distinctive and stands out in the marketplace.
- Focus on meeting or exceeding the needs of specific customer groups.

Companies that manage to grow in the same old market with the same old product do so by continually generating new demand as well as maintaining or even increasing their market share. Often, these companies succeed in slowing the product life cycle, extending its maturity stage almost indefinitely. In some cases, they even manage to reset the life cycle, pulling the product back into the growth stage by inventing new and creative product uses. But steady and sustained market penetration based on a single product doesn't always work forever, and companies sometimes have to look in new directions for growth.

New market or new product

At some point in the life of your company, a single product or service may not be enough to sustain an attractive level of growth in your business. Where do you turn? The Growth Directions Matrix (refer to Figure 14-2, earlier in this chapter) suggests that the most reliable and productive paths point to market expansion in the near term, as well as to extending your product line. These two directions for growth have the distinct advantage of building on capabilities and resources that you already have. Market expansion leverages your current product expertise, and product extension builds on your experience and knowledge of current customers and the marketplace.

Successful big-name companies such as Timex, Coca-Cola and McDonald's are usually much bigger than just the flagship products that we associate with them, and if you look closely at the ways in which they grow, they almost always do so through a combination of expanding into new markets and extending their product lines. What Ford was to cars, Timex was to the wristwatch. When the Timex wristwatch arrived in the 1950s, it echoed Henry Ford's achievement with the Model T 40 years earlier. But just as Ford stretches from trucks to micro's such as its Ka, Timex has extended its offer into all aspects of time. During the Second World War, the company converted its factories to making high-quality, mechanically timed artillery and anti-aircraft fuses. Now they've 'timing devices' that can manage your time as well as keep it, handle your fitness programme, control your mp3 player and monitor your heart rate. Coca-Cola enters new markets throughout the developing world by offering a family of cola beverages that includes Classic Coke, Diet Coke and Caffeine-free Coke. And McDonald's is open for breakfast, lunch and dinner with Egg McMuffins, Big Macs and Chicken McNuggets, while at the same time making subtle variations to its products to fit in with local market needs: salads and wine in France, and even English language tuition for children in Japan, using the menu as the vocabulary.

New market

Expanding into a new market is something that your company can do rather quickly, because it can take advantage of its current business model, copying many of the activities that it already engages in – producing, assembling and distributing products, for example.

You can expand your market in two basic ways: move into new geographical areas or go after new market segments:

- **Geography:** The most obvious way to grow beyond your core product and market is to expand geographically, picking up new customers based solely on where they live and work. This kind of expansion has many advantages. You not only do business in the same way as before, but you also have a head start in understanding many of your new customers, even with their regional differences. Because geographic expansion may require you to do business in unfamiliar areas or even new countries, however, you have to pay special attention to how your company must change to accommodate the specific demands of your expanded market.
- **New market segments:** Sometimes you can expand the market for your product or service by finding new kinds of customers. If you're creative, maybe you can identify a group of customers that you've neglected in the past. Look carefully at your product's features and packaging, how the product is priced and delivered, who's buying and why they buy. Also, reassess the customer benefits that you provide. Then ask yourself how attractive a new market segment is in terms of its size and potential to grow. What strengths do you bring to the market? What competitors are already there? How do you plan to gain an advantage over the long haul?

New product

Extending the number of products or types of services that you offer is something that you should plan for well ahead of time. All too often, companies develop new product features, options and major product enhancements without giving much thought to the implications for the company's future direction and growth. Instead, a customer asks for this or that special feature, or a distributor requests a particular option or accessory, and before you know it, you've additional products to support.

The good news, of course, is that you already have customers. But you also have to be sure that those customers represent a larger market that benefits from your product extension and that the additional products make sense in terms of your own business strategy and plan.

You can extend your product or service in two basic ways: offer new features and options or create related families of products:

- **New features and options:** The most common way to extend a product line involves adding bells and whistles to your product and giving customers the chance to choose which bells and whistles they want. The advantages are easy to tick off: you work from your existing strengths in product design and development, and you use real live customers to help you decide which incremental changes to make. It sounds like the perfect game plan.

  The danger comes from losing track of the bigger picture – where you want your company to end up. Individual customers, no matter how good they are, don't always reflect the direction of larger markets. So avoid creating a bunch of marginal products that you can't really sell or support. Instead, plan to develop a smaller number of products with features and options that are designed to meet the needs of specific market segments.

- **Related product groups:** You may create a group of products based on a common element of some sort. You can develop a product family to use the same core technology, to meet a series of related customer needs or to serve as accessories for your primary product.

  You want the product group to look stronger in the market than the individual products do separately. That way, the risks inherent in product development are reduced, and the rewards are potentially greater. Take time to understand just how products in the group actually work together. Also, make sure that you address the separate challenges that each product poses in terms of customers, the competition and your own company's assets and capabilities.

Before you put your plans for growth into action, make sure that they draw on your company's strengths, reflect the capabilities and resources that you have available and help to maintain your competitive advantage. Ask yourself the following questions:

- How well are you doing in the markets that you're already in?
- In what ways is the expanded market different from your current market?
- What parts of your business can you leverage in the expanded market?
- What functions and activities have to change to accommodate more products?
- How well will your extended product line meet specific customer needs?

- Is your extended product family stronger than each product by itself?
- How easy is it to scale up your business to meet the expected growth?
- How will your competitive environment change?

New product and new market

Has your company hit a midlife crisis? Do you find yourself searching for attractive new customers, sexy technologies and aggressive competition? Well, a company often thinks about rejuvenating itself from time to time. A plan to move in new directions often involves diversifying the company, moving down into the bottom-right corner of the Growth Directions Matrix (refer to Figure 14-2 earlier in this chapter). That corner, after all, is where the grass always looks much greener – and the profits look greener, too.

WARNING!

But you have to balance the potential rewards against the challenges and risks that go along with diversification. Too many companies end up looking foolish as they try to learn new tricks in unfamiliar businesses without much time to practise – and they often face the financial consequences.

To better your odds of success, start by doing your homework, which means researching all the new issues and new players. If this task sounds daunting, it should be. The stakes couldn't be much higher.

Your chances of success improve substantially when you identify the ways that a potential new business is related to what your company already does. But even without the benefit of any existing product or market expertise, you can often discover aspects of a new business opportunity that play right into your company's core competence (flip to Chapter 9 for more on that). The following shows what to look for:

- **Name recognition:** If your company has worked hard to create a name for itself, you can sometimes make use of its brand identity in a new business situation. Name recognition is particularly powerful when the associations are positive, clearly defined and can be carried over to the new product and market. Luxury-car companies such as BMW, for example, now give their names to expensive, upmarket lines of touring and mountain bikes.
- **Technical operations:** The resources and skills required to design, develop or manufacture products in your own industry – or perhaps the technical services that you offer – may be extended to support additional product areas. Japanese electronics giants such as Sony and Mitsubishi, for example, are experts in miniaturisation, automation and quality control. Given those skills, they can acquire original technology or experimental products and then go on to create product lines based on their expertise.
- **Marketing experience:** If your company has a great deal of marketing expertise available, you can often put that expertise to good use to expand the awareness and strengthen the positioning of a new product. Examples include the creative software products that small, independent developers produce and then sell to larger companies such as Symantec or Netscape – companies

that have the marketing muscle to successfully advertise, promote and distribute those products.

- **Capacity and scale:** Sometimes you can take the excess capacity that your company has in production, sales or distribution and apply that capacity directly to a new business area. That way, you reap the benefits of a larger scale of operations and use your resources more efficiently. Many car dealerships around the UK, for example, reached out in the 1980s to show, sell and service Toyotas and Hondas, permanently adding them to their British car lines. Now, of course, that's all that UK motor dealerships have to offer, so their new products eventually became their main and only products.
- **Financial considerations:** Persistent demands on your company's revenue, cash flow or profits may inevitably point you in a new business direction. Although a financial opportunity by itself offers a fairly flimsy link to your existing products and markets, a new business may – just may – be justified on the basis of financial considerations alone. Large tobacco companies, for example, use their huge cash reserves to diversify into unrelated business areas that have brighter, smoke-free futures.

The temptation to set off in new directions and diversify into new businesses, creating brand-new products for brand-new markets, has bewitched and bothered business planners for decades. Unfortunately, the failure rate for new products can be as high as 75 per cent. And the most perplexing part of the puzzle is the fact that in the beginning, everything looks so good on paper. Here are some examples:

- Campbell Soup Company thought that it had a winner when it decided to launch a family of juice drinks for kids. But its Juice Works brand had trouble, in part because so many competitors had better brand-name recognition in the juice business.
- Federal Express set out to create the future of immediate document delivery by introducing a new computer network-based product. But customers turned to FedEx to send hard copy, not email, and the company got zapped by its Zap Mail service.
- Laura Ashley, co-founder with her husband Bernard of the firm of the same name, never liked the concept of fashion, insisting instead that her clothes and furnishings were designed to endure. In the 1960s, the company's fresh cotton print dresses offered a clear alternative to the miniskirts of Mary Quant. In the late 1980s, following Laura Ashley's tragic death, the company made the mistake of trying too hard to get with it, downplaying its heritage, neglecting its long print tea-dresses and Viyella checks. The flirtation with fashion was a disaster, heralding a decade or so of revolving doors at management level, and strategic twists and turns that make fascinating, if depressing, case study material for MBA classes the world over.

A few companies, however, manage to succeed with new products and markets time and time again. Think Tesco, and you could be forgiven for thinking of value food in the UK. But the company has successfully introduced thousands of non-food products in the past decade – everything from fashion clothing to microwaves; they even have a substantial personal finance business, and perhaps the world's only profitable Internet home delivery service. Tesco's stated goal is to bring value, choice and convenience to customers, notice that they don't mention food here. This goal is the one it pursues with vigour in Asia, Central and Eastern Europe and the US.

Sounds like a summary is in order here:

- One way to grow is to encourage customers to use more of your existing product more often and in more ways.
- To grow in new directions, your company has to look to new products, new markets or entirely new businesses.
- When you expand into a new market, you can take advantage of expertise in creating and delivering your existing product.
- When you extend your product line, you can take advantage of your knowledge of customers and the marketplace.
- When you go after a totally new business (new product, new market), the stakes are high, so do your homework.

Understanding the adoption cycle

Customers are usually not hanging around hoping for new products or services to arrive so they can rush out to buy them. Word spreads slowly as the message is diffused throughout the various customer groups. Even then, you notice that generally the more adventurous types first buy into new ideas. Only after these more adventurous customers have given their seal of approval do the 'followers' come along. Research shows that this *adoption process*, as it is known, moves through five distinct customer characteristics, from Innovators to Laggards, with the overall population being different for each group. Check out Figure 6-2 in Chapter 6 for an illustration of the process.

Suppose that you've identified the market for your Internet gift service. Initially your market has been confined to affluent professionals within five miles of your home to keep delivery costs low. So if market research shows that 100,000 people meet the profile of your ideal customer and they've regular access to the Internet, the market open for exploitation at the outset may be as low as 2,500, which is the 2.5 per cent of innovators.

This adoption process, from the 2.5 per cent of innovators who make up a new business's first customers, through to the laggards who won't buy from anyone until they've been in business for 20 years, is most noticeable with truly innovative and relatively costly goods and services. The general trend, though, is true for all businesses. Until you've sold to the innovators, you can't achieve significant sales. So, an important first task is to identify these innovative customers. The moral is: the more you know about your potential customers at the outset, the better your chances of success.

One further issue to keep in mind when shaping your marketing strategy is that innovators, early adopters and all the other sub-segments don't necessarily use the same media, websites, magazines or newspapers, or respond to the same images and messages. So you need to market to them in very different ways.

Protecting intellectual property

The holy grail for new products or services is to find one with sufficient unique advantage to make it stand out from others in the market. You must also ensure that your advantage cannot be easily copied. In other words, you need to put up a barrier to entry, preventing others from following the same path to riches.

The most effective way to safeguard the unique nature of your product is to establish it as your *intellectual property*, usually shortened to IP. IP splits down into a number of distinct areas:

- **Patents** that involve an inventive step capable of industrial exploitation.
- **Copyright** that gives protection against the unlicensed copying of original artistic and creative works – articles, books, paintings, films, plays, songs, music, engineering drawings.
- **Design registration** that covers the shape, design or decorative features of a commercial product if it is new, original, never published before or – if already known – never before applied to the product you have in mind.

You can get help with IP from these organisations:

- The UK Intellectual Property Office (www.ipo.gov.uk) has all the information needed to patent, trademark, copyright or register a design.
- The European Patent Office (www.epo.org), the US Patent and Trade Mark Office (www.uspto.gov) and the World Intellectual Property Association (www.wipo.int) can all give information on international intellectual property issues.

- The Chartered Institute of Patents and Attorneys (www.cipa.org.uk) and the Institute of Trade Mark Attorneys (www.itma.org.uk), despite their specialised sounding names, can help with every aspect of IP, including finding you a local advisor.

Managing Your Product Portfolio

When you decide that the time is right to branch out into new products and markets or to diversify into new businesses, you're going to have to learn how to juggle. You no longer have the luxury of doting on a single product or service; now you've more than one product and market to deal with. You have to figure out how to keep every one of your products in the air, providing each one with the special attention and resources that it needs, depending on which part of the product life cycle it's in.

Looking at strategic business units

Juggling usually requires a bit of preparation, of course, and the first thing that you want to find out is how many oranges and clubs – or products and services, in this case – you have to keep in the air at one time. You can count oranges easily, and counting clubs isn't tough, either. For products and services, though, the following questions tend to pop up. Often, these questions have no right answer, but just taking time to think through the issues helps you better understand what you offer. Ask yourself:

- Just how many products or services does your company have?

- When you add another feature or an option to your product, does the addition essentially create a new product that requires a separate business plan?
- When you've two separate sets of customers using your service in different ways, do you really have two services, each with its own business plan?
- When you offer two different products to the same set of customers, each of which is manufactured, marketed and distributed in much the same way, are you really dealing with one larger product area and a single business plan?

General Electric struggled with these questions in the late 1960s. The company had grown well beyond the original inventions of its founder, Thomas Edison; it wasn't just in the electric light bulb business any more. In fact, it was a diversified giant, with businesses ranging from appliances and aircraft engines to television sets and computers. The company had to decide on the best way to divide itself up so that each piece was a manageable size and could be juggled with all the other pieces.

The managers at General Electric hit on the clever idea of organising the company around what they called strategic business units. A *strategic business unit* (SBU) is a piece of your company that's big enough to have its own well-defined markets, attract its own set of competitors and demand tangible resources and capabilities from you. Yet an SBU is small enough that you can craft a strategy with goals and objectives designed to reflect its special business environment. By using the SBU concept, General Electric transformed nearly 200 separate, independent product departments into fewer than 50 strategic business units, each with its own well-defined strategy and business plan.

Consider ways to reorganise your own company around strategic business units. Each time you outline a separate business plan, you identify a potential SBU. How do you get started? Because strategic business units often refer to particular product and market areas taken together, begin with the following steps:

1. **Break your company into as many separate product and market combinations as you can think of.**
2. **Fit these building blocks back together in various ways, trying all sorts of creative associations of products and markets on different levels and scales.**

   Think about how each combination may work in terms of creating a viable business unit.
3. **Keep only those combinations of products and markets that make sense in terms of strategy, business planning, customers, the competition and your company's structure.**
4. **Step back to determine how well these new SBUs mesh together and account for your overall business.**

   If you don't like what you see, try the process again. Don't make the changes for real until you're satisfied with your new organisation.

Aiming for the stars

Rather than juggle a set of who knows how many ill-defined products, practise your juggling technique on the Strategic Business Units (SBUs) that you identify instead.

Start by dividing your SBUs into two basic groups, depending on the direction of their cash flow: put the ones that bring money into your company on one side and the ones that take money out on the other side. Maybe you're surprised that you've two sides here. Because every product goes through a life cycle that's likely to include an introduction stage, growth, maturity and then decline, different SBUs naturally have different cash-flow requirements. You must invest in products during their introduction and growth phases, and your mature products end up paying all the bills. So as a successful juggler, you always need at least one mature SBU aloft to support the SBUs that are coming along behind.

Some of this juggling stuff may sound familiar if you've ever tried to manage your own personal savings or retirement accounts. Every financial adviser tells you the same thing: spread your investments out to create a more stable and predictable set of holdings. Ideally, financial advisers want to help you balance your portfolio based on how much money you need to earn right away and what sort of nest egg you expect to have in the future. Given your financial needs and goals, planners may suggest buying blue-chip stocks and bonds that generate dividends right away, and also investing in more speculative companies that pay off well down the road.

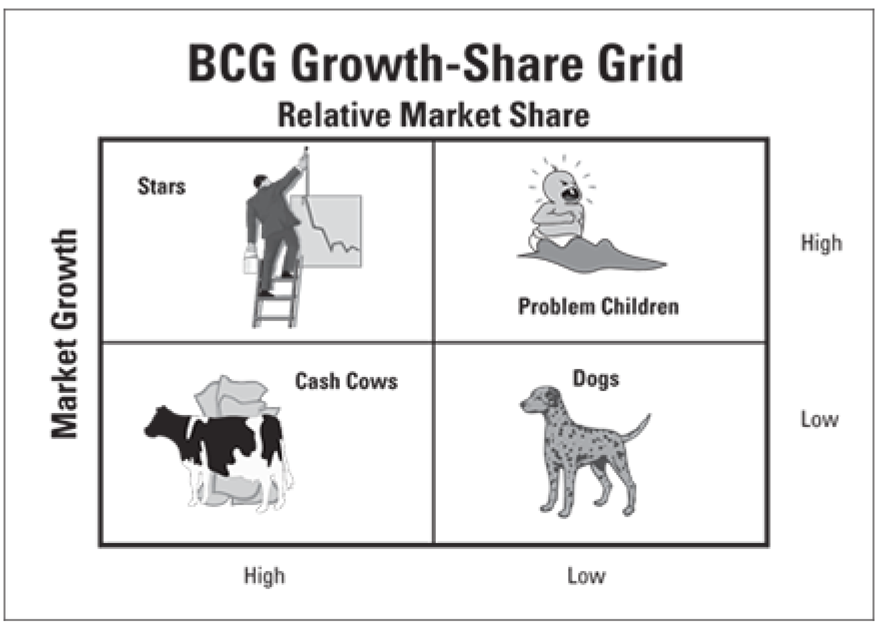
JARGON ALERT

Your company's SBUs have a great deal in common with a portfolio of stocks and bonds – so much, in fact, that the SBU juggling that we're talking about is called *portfolio management*. To manage your own SBU portfolio as professionally as financial experts track stocks and bonds, you need guidance, which is where portfolio analysis comes in. *Portfolio analysis* helps you look at the roles of the SBUs in your company and determine how well the SBUs balance one another so that the company grows and remains profitable. In addition, portfolio analysis offers a new way to think about strategy and business planning when you've more than one strategic business unit to worry about.

You could make your first attempt at simple portfolio analysis with two SBU categories: those that make money and those that take money. Then all you have to do is make sure that the first category is always bigger than the second. But the two categories don't give you much help in figuring out what's going to happen next. Fortunately, the people at the Boston Consulting Group came up with an easy-to-use portfolio-analysis tool that provides some useful planning direction.

The Boston Consulting Group's Growth-Share Grid (see Figure 14-3) directs you to divide your SBUs into four groups.

Figure 14-3: The Growth-Share Grid divides your company's SBUs into four major groups.



You base your portfolio analysis on two major factors: market growth and market share:

- **Market growth:** Is the SBU part of a rapidly expanding market, or does it fall somewhere in a slow- or no-growth area? You use market growth to define your portfolio because it forces you to think about just how attractive the SBU may be over the long haul. The exact point that separates high-growth and low-growth markets is rather arbitrary; start by using a 10 per cent annual growth rate as the midpoint.

- **Relative market share:** Does your SBU command a market-share advantage over its nearest competitors, or does its market share place it down the list relative to the competition? You use relative market share as a major characteristic to define your SBU portfolio because all sorts of evidence suggests that a strong market-share position is closely tied to the profitability of the SBU. Separate your SBUs into those where you have the highest market share and those where you don't.

Here's a review of the types of SBUs:

- **Problem children:** *Problem children* are SBUs that have relatively low market share in high-growth markets. Problem children often represent newer businesses and are sometimes referred to as *question marks*, because you aren't quite sure which path these SBUs may take. Because problem children are in expanding markets, these SBUs require lots of cash just to tread water, maintaining what market share they already have, but their relatively low sales tend to generate little or no revenue in return. If you can substantially increase their market share over time – and that means shelling out even more cash – problem children can blossom into stars. If not, you may have to give them up.
- **Stars:** *Stars* are SBUs that have a dominant market-share position in high-growth markets. Every SBU wants to be a star. Stars usually have an expensive appetite for the

cash to fund continual expansion and to fend off competitors that are eager to get a piece of the turf. But their market-share advantage gives these SBUs an edge in generating revenue, high margins and profits. On balance, stars usually support themselves, both producing and consuming large amounts of money. You shouldn't hesitate to step in and support a star SBU, however, if additional resources are required to maintain its market-share lead.

- **Cash cows:** The name *cash cows* says it all – these SBUs have a major market-share position in low-growth markets. Because of their market-share advantage, these SBUs generate a great deal of cash, and the best part is the fact that they don't require much in return. Their low-growth markets usually are mature, and the products are already well-established. The bottom line: you can milk cash cows to produce a cash surplus and then redirect that cash to fund promising SBUs in other quadrants.
- **Dogs:** *Dogs* are SBUs that deliver low market share in low-growth markets – and little else. Although many of us are dog lovers, it's hard to love this particular breed. Revenue and profits are usually small or non-existent, and the SBUs are often net users of cash. Although they require periodic investments, these marginal businesses usually never amount to much, so it may be best to turn your attention to more-promising SBU candidates.

Now you need to put all the pieces together so that you can construct a Growth-Share Grid to represent your own portfolio of SBUs. Ideally, of course, you see mostly stars and cash cows, with enough problem children (the question marks) to ensure your company's future. Ideally, you've few dogs to contend with.

But the world isn't always ideal. Fortunately, you can also use the Growth-Share Grid as a tablet to sketch out what you plan to do with your SBUs to balance them in the future. The following is what you do:

1. **Sort through your company's SBUs, and get ready to put them in a blank Growth-Share Grid.**

   To see the grid format, refer to Figure 14-3 earlier in this chapter.

2. **Place each SBU in its proper quadrant, given what you know about market growth and the SBUs relative market share.**

3. **Draw a circle around each SBU to represent how big it is in relation to your other SBUs.**

   Base the size of your SBUs on revenue, profits, sales or whatever measure is most convenient.

4. **For each SBU in the grid, forecast its movement in terms of overall market growth and market-share position.**

   Use a time frame that's appropriate for your industry and its rate of change.

5. **To capture this forecast, draw arrows indicating the direction of movement and where you plan to have each SBU end up in the future.**

   Arrows that point outside the grid indicate that you plan to get rid of the SBUs in question.

The BCG Growth-Share Grid, with its quirky cast of characters and its black-and-white view of the world, is hard to resist, because it makes the complex, difficult job of juggling several businesses seem to be almost effortless. After it first caught on nearly 30 years ago, however, the model became so widely overused and misapplied that the entire business of understanding business portfolios went out of fashion. Today, of course, we understand that portfolio-analysis tools have their place, but they have to be used sensibly. As the saying goes, if something looks too easy to be true, it probably is.

Before you start moving your SBUs around the Growth-Share Grid like pieces on a chessboard, remind yourself that the following strings are attached:

- Market growth is singled out as the only way to measure how attractive a market is and to determine whether or not you'd like to be in business there. But growth isn't the only interesting variable. Markets may turn out to be attractive because of advances in technology, changes in regulation, profits – you name it.
- Relative market share alone is used to describe how competitive you are and how profitable your company is likely to be. But market share is really relevant only when you're competing on the basis of size and sales volume. You have other ways to compete, including making your product unique in some way, focusing on a particular group of customers or concentrating on service.

- The SBUs in the Growth-Share Grid are linked only by the flow of cash in and out of the different businesses. But you've many other ways to think about how SBUs may relate to one another and function together, including views that stress the competition or focus on market risk factors.

- The differences between a star and a cash cow (or a problem child and a dog) are arbitrary and subject to all sorts of definition and measurement problems, so without careful analysis and a dose of good judgement, you can easily cast your SBUs in the wrong roles. You may end up abandoning a problem child too soon, for example, because you think that the SBU is a dog, or you may neglect and hurt a star SBU by assuming it to be a cash cow that you can milk for money.

Looking strong and attractive

If you feel that the Growth-Share Grid doesn't represent your own business situation (if you'd like something in Technicolor, maybe with a few more bells and whistles), dozens of other models, methods and tools are available, all of which promise to guide you to the right answers with little fuss. Many of the other models claim to work particularly well for certain industries or in specific business conditions, and one of them may be just right for your company. But before you turn to the pros for guidance, however, you may want to take one more step in analysing your SBU portfolio on your own.

During the 1960s, General Electric (with the help of the consulting gurus at McKinsey and Company) came up with a portfolio-analysis framework that's a little more complicated than the Growth-Share Grid. But the GE Framework is richer and can be applied successfully in a wider range of business situations.

To make use of the GE Framework, start by examining the complicated-looking box shown in Figure 14-4.

Don't worry; we can help. The GE Framework creates two primary categories that shape your SBU portfolio analysis: industry attractiveness and your business strengths. Unlike the Growth-Share Grid, the GE Framework requires you to go on and define exactly what you mean by *industry attractiveness* and *business strengths*.

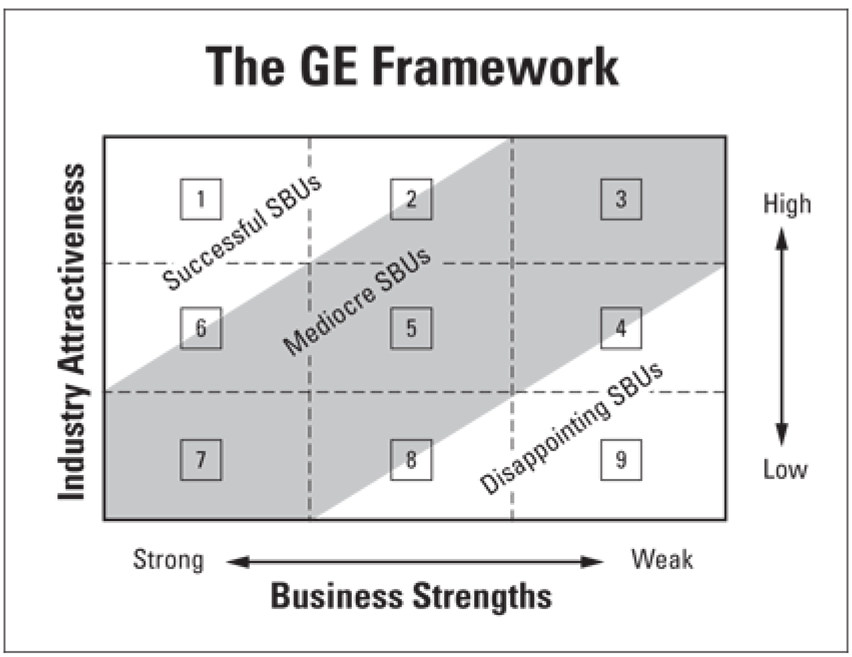


Figure 14-4: The GE framework arranges your company's SBUs into three bands and nine boxes, based on the strength of each SBU and its industry's attractiveness.

Coming up with what's attractive and what's a strength can be more ambiguous and less obvious than dealing with market-growth figures and relative market-share numbers. These definitions should help you get started:

Industry attractiveness: This category may include any number of components, depending on your industry. In most situations, however, you want to emphasise the factors that are likely to lead to fatter returns on your own SBU investments. Some of the things that you should look at (in addition to the overall market growth rate) are:

- Industry size
- Industry ups and downs
- Intensity of competition
- Customer and supplier relationships
- Average revenue and profits
- Rate of innovation
- Entry and exit barriers (see Chapter 7 for more details)
- Government regulations

Business strengths: This category should be based on your specific business situation relative to your industry. Instead of relying on relative market share as the only indication of your company's capability to compete, you should include other factors that reflect your company's particular strengths and advantages, such as the following:

- Product uniqueness
- Service quality
- Customer loyalty
- Brand recognition

- Costs and profitability
- Manufacturing capacity
- Research and development
- Patents
- Organisational skills

Rearrange your SBU portfolio so that every strategic business unit falls somewhere in one of the nine newly minted boxes (flip back to Figure 14-4 for your template). Depending on the location of each box, the GE Framework presents a set of planning guidelines. Here are the options that the numbered boxes suggest:

1. **Protect position.** Concentrate your resources and efforts on maintaining your strengths. Invest to grow at a fast but manageable pace.
2. **Try harder.** Challenge the market leaders. Build up the aspects of your company that are strong and reinforce areas in which the company is vulnerable.
3. **Be choosy.** Seek ways to overcome your business weaknesses. Keep an eye open for new opportunities if the risks are low.
4. **Harvest.** Limit your investments, and try to reduce costs to maximise your profits. Back away if you begin to lose ground.
5. **Manage carefully.** Maintain your existing programmes. Concentrate any new investments in promising areas in which the risks are manageable.
6. **Grow wisely.** Build on your competitive position. Invest in attractive areas in which you can gain or need to maintain an advantage.
7. **Regroup.** Try to preserve your current cash flow. Defend your strengths, and focus on areas that remain attractive.

8. **Coast along.** Keep any further investment to the bare minimum. Protect the position that you have, and try to sustain revenue.

9. **Get out.** Cut your costs to the bare bones, and avoid making any new investments. Bide your time until you can sell to the highest bidder.

Bear the following in mind:

- If you offer more than one product or service, manage your offerings like a portfolio, with an eye toward how the components work together.
- A strategic business unit (SBU) is a particular product/market combination that typically requires its own business plan.
- You can divide SBUs into stars, problem children, cash cows and dogs, depending on market growth and market share.
- Place your bets on SBUs in attractive industries that take advantage of your company's strengths.

Market size matters. In Chapter 8 we look at measuring market share, and we explain the importance of the relationship between the total lifetime volume of a product or service and the cost of assembling and delivering it. Unsurprisingly the costs fall in line with volume, giving a cost advantage to the business that has made the most units of a product. The message here is not to spread too thinly across lots of SBUs, but aim as far as possible for the ones in which it could be possible to be an important player in the market.

Hastening slowly

First mover advantage is a phrase used like a mantra to justify high expenditure and a headlong rush into new strategic areas. This concept is one of the most enduring in business theory and practice. Entrepreneurs and established giants are always in a race to be first. Research from the 1980s showing that market pioneers have enduring advantages in distribution, product-line breadth, product quality and, especially, market share underscores this principle.

Beguiling though the theory of first mover advantage is, the theory is probably wrong. Gerard Tellis, of the University of Southern California, and Peter Golder, of New York University's Stern business school, argued in their book *Will and Vision: How Latecomers Grow to Dominate Markets* (published by McGraw-Hill Inc., US) and in their subsequent research that previous studies on the subject were deeply flawed. In the first instance, earlier studies were based on surveys of surviving companies and brands, excluding all the pioneers that failed. This omission helps some companies to look as though they were first to market even when they were not. Procter & Gamble (P&G) boasts that it created America's disposable nappy (diaper) business. In fact, a company called Chux launched their product a quarter of a century before P&G entered the market in 1961.

Also, the questions used to gather much of the data in earlier research were at best ambiguous, and perhaps dangerously so. For example, the term 'one of the pioneers in first developing such products or services', was used as a proxy for 'first to market'. The authors emphasise their point by listing popular misconceptions about who the real pioneers were across the 66 markets they analysed. For example, in online book sales: Amazon (wrong), Books.com (right); in photocopiers, Xerox (wrong), IBM (right); in PCs, IBM/Apple (both wrong), Micro Instrumentation Telemetry Systems (MITS; right).

In fact the most compelling evidence from all the research was that nearly half of all firms pursuing a first-to-market strategy were fated to fail, while those following fairly close behind were three times as likely to succeed. Tellis and Golder claim that the best strategy is to enter the market well after pioneers, learn from their mistakes, benefit from their product and market development and be more certain about customer preferences.

Extending Your E-Penetration

The online world has come a long way since eBay and a handful of other brave souls blazed the trail. Today, a visible place in cyberspace is all but essential if you want to make any impact on the wider business world. Alongside the greater use of the Internet, just as with computers, the price of getting online is dropping sharply and the power and quality of what those fewer bucks will buy is immeasurably improved. Everything from books and DVDs, through computers, medicines and financial services on to vehicles and property is being sold, or having a major part of its selling process transacted online. Holidays, airline tickets, software, training and even university degrees are bundled in with the mass of conventional retailers such as Tesco, who fight for a share of the ever growing online market. According to thelatest figures from The Office for National Statistics (www.ons.gov.uk) Internet retail sales now account for approximately 10.5 per cent of all retail sales. This figure is the highest proportion since the series began and is 7.9 per cent up on the preceeding year. On average, weekly Internet retail sales totalled £660 million compared with the average weekly value for all retailing at £6,300 million (excluding automotive fuel).

At the time of writting, the average weekly value for Internet retail sales is growing by 37.5 per cent a year while the average weekly value for all retailing is almost static.

Not all business sectors are penetrated to the same extent by the Internet; according to Forrester (www.forrester.com), the Internet research company, although sales of clothing and footwear online is a multi-billion business, it only accounts for 8 per cent of total sales. Contrast that with computers, where 41 per cent of sales occur online.

According to eMarketer (www.emarketer.com), 88 per cent of shoppers prefer online to conventional shopping because they can shop at any time; 66 per cent like being able to shop for more than one product and in many outlets at the same time; 54 per cent claim to be able to find products they can only find online; 53 per cent like not having to deal with sales people; 44 per cent reckon product information is better online; and perhaps the most revealing statistic of all, only 40 per cent preferred online to offline because they expected to find lower prices.

All the above is to say that the Internet is important – but also different and even selling the same product or service online represents a different product or market competitive environment. So, for example, Tesco sells wine in its stores on the shelf with nothing more than the labels to explain the product on offer. Online, the website is full of information on wine, tasting notes, a magazine and a wine club. Online, Tesco competes with companies such as Laithwaites who don't have a retail presence at all.

So you need to run through all of this chapter twice. Once for your bricks (your real-world business) and once more for the clicks (your online activities): the dynamics are different.

Buying Out Competitors

One strategy that encompasses all of those discussed earlier in the chapter is an acquisition. Each year, about 2,000 private companies change hands in the UK alone. The average size, in turnover terms, of the companies bought and sold was under £7 million per annum, with many having sales below £0.5 million. Forty-five per cent of the acquisitions were viewed as wholly amicable. There was a willing buyer and a willing seller, and no other parties were involved. Another 45 per cent were classified as partly contested, because there were several interested buyers, or because there was resistance within the vendor to being taken over. Only 10 per cent of the acquisitions were hostile, with a bid being made over the heads of the vendors' board. These contested bids are the deals that make the headlines, but, as you can see, the reality is that an awful lot of quite small companies are changing hands in a fairly friendly way, for modest sums of money.

When economic growth is virtually static, or if you want to achieve really dramatic growth, then buying someone else's business can be a very attractive option.

WARNING!

Even when acquisitions take place under friendly or fairly friendly conditions, only 55 per cent were eventually rated as successful or very successful by both buyers and sellers. So buying a company is certainly not always a sure-fire winning strategy.

Use a seven-point plan – based on issues we cover in the following sections – to make sure that you can end up with the most successful acquisition, merger or joint venture you can.

Knowing why you want to buy

Big companies end up on the takeover trail for matters of management ego as much as corporate strategy. Over 40 per cent of big companies listed ‘sending signals to the City’ as their principle reason for buying. A further 35 per cent put it down to the ‘chairman’s insistence’. Not surprisingly, many acquisitions are financially unrewarding or worse. Sound reasons for acquisitions include:

- To increase market share and eliminate a troublesome competitor.
- To broaden your product range or give you access to new markets.
- To diversify into new markets acquiring the necessary management, marketing or technical skills to enable you to capture a reasonable slice of the market relatively quickly.
- To get into another country or region.
- To protect an important source of supply that could be under threat from a competitor.
- To acquire additional staff, factory space, warehousing and distribution channels, or to get access to additional major customers more quickly than by starting up yourself.

Produce a written statement explaining the rationale behind your reason to buy – before you start looking for companies to buy – otherwise you could end up pursuing a 'bargain' just because it seems cheap, that has absolutely nothing to do with your previously defined commercial goals. Also, remember that companies available at knockdown prices are likely to need drastic surgery. So unless you fancy your chances as a company doctor, stay well away.

Investigating and approaching

Once you have your shopping list of prospective purchases, you need to arm yourself with everything you can find out about them. Visit their website, get their literature, samples, copies of their advertising, press comment and, of course, their accounts. Then get out and see their premises and as much of their operation as you're able to. If you can't get in, get one of your salespeople in to look the business over for you. This investigation helps you to both shorten your shopping list, and put it into order of priority. Now you're ready for the approach.

Although you're technically *buying*, psychologically you would be well advised to think of acquiring a company as a *selling* job. As such, you cannot afford to have any approach rejected too early or without a determined effort. You've three options as to how to make the initial approach and each has its merits. You can do any of the following:

- Telephone, giving only the broadest reason for your approach – saying perhaps that you wish to discuss areas of common interest.

- Write and be a little more specific on your purpose, following that up with a phone call to arrange a meeting, perhaps over lunch.
- Use a third party such as an accountant, merchant bank or consultant. Reasons of secrecy could make this method desirable. If executive time is at a premium, there may be no other practicable way.

The first meeting is crucial and you need to achieve two objectives. First, you must establish mutual respect, trust and rapport. Nothing worthwhile follows without these. Then you need to establish in principle that both parties are seriously interested. Time scale, price, methods of integration and other matters can all be side-stepped until later, except in the most general sense.

Valuing the business

Once you've found a business that you want to buy, and that is probably for sale, you will now need your accountants to investigate the business in depth to see exactly what is on offer. This investigation can take several weeks, and is a little like having a house surveyed. You need to remember that accounts are normally prepared on the *going concern* basis, which implies that the company is going to continue trading much as before. This means that the historical cost of fixed assets such as buildings, land, machinery and so on can appear in the balance sheet, rather than the market worth. After all, until you came along they hadn't planned to sell their fixed assets, but now the figures will have to be recast using different principles.

Ultimately, what you're buying is extra profit or, perhaps, lower costs in your own business. You have to decide how much that is worth. Public companies usually have general rules for each sector. For example, much of the retail sector is valued on a price/earnings ratio (P/E) of 12, which means that retailers are seen as being worth 12 times last year's net profit. A private company in the same sector would only be worth two thirds that figure, as their shares are less easily bought and sold. The worth of the assets in the business would also be important, and whatever the nature of the business you're usually buying people – their knowledge and skills – unless of course you're simply *asset stripping* (buying a business primarily to sell off its assets rather than to continue to run it).

Prices paid for private companies are monitored in a three-monthly index prepared by accountancy firm BDO Stoy Hayward. (www.bdo.uk.com/ publications/private-company-price-index.html). Based on completed acquisitions, the index tracks the ratio between the purchase price of private companies sold during a three-month period and their historical earnings.

The P/E ratio of the index of private companies is usually about 20 per cent lower than the trading P/E multiple of companies in the FT Index for the same period. This reflects the value placed on liquidity. No great science is involved in valuing businesses, just a rather messy art. At the end of the day, you can always work out if it would be cheaper to start up from scratch yourself. That gives you an outer figure for your negotiations. Any higher purchase price would not represent good value, as you could start up yourself for less money.

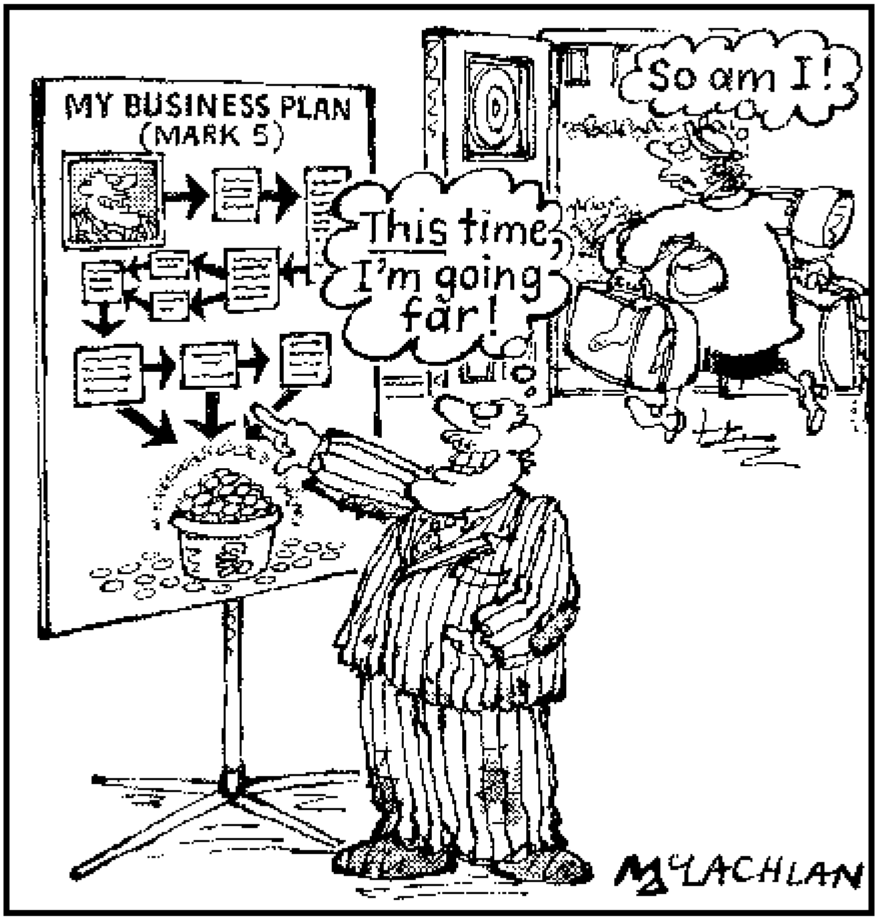
Limiting the risks

Buying a business is always risky. If you've done your homework and got the price right, with any luck the risks will be less. Some other things you can do to lessen the risks include the following:

- **Set conditional terms.** For example, you could make part of the price conditional upon a certain level of profit being achieved.
- **Handcuff key employees.** Not literally, you understand, but if most of the assets you're buying are on two legs, then get service contracts or consultancy arrangements, either of which get a degree of commitment in place before the deal is signed, so that you can be sure they will be around for a while at least.
- **Insert non-competition clauses.** Make sure that neither the seller nor her key employees can set up in competition, taking all the goodwill you've just bought.
- **Get tax clearances.** Obviously you want to make sure that any tax losses you're buying, or any tax implications in the purchase price, are approved by Her Majesty's Revenue and Customs, before committing yourself.
- **Insist on warranties and indemnities.** If, after you've bought, you find a compulsory purchase order on the vendor's premises and the patent on his new product is invalid, you would quite rightly be rather miffed. Warranties and indemnities set out those circumstances in which the seller makes good the buyer's financial loss. So anything crucial that looks worrying, you could try to include under this heading. Not unnaturally, the seller is going to resist, but you need to be firm on key points.

Part V

A Planner's Toolkit



In this part . . .

Whatever the task you're involved in, no matter how big or small, there comes a time when you have to roll up your sleeves and get down to the real business at hand. Once you know where you're headed and what you're going to do, you must go out and do the task itself. The best plans in the world aren't worth anything if you can't carry them out.

In this part, we help you put your business plan to work. First, we look at ways to organise your company, and develop the procedures and systems that allow you to carry out your plan as efficiently and effectively as possible. Second, we talk about ways to encourage leadership, develop business skills, and create a company culture so that you can achieve your plan. Third, we look at financing your plan and planning to bow out gracefully. Finally, we show you a sample business plan, so that you have a better idea of exactly what lies ahead for your company.

Chapter 15

Planning in Turbulent Economic Times

In This Chapter

- Recognising the warning signs
- Figuring a way through the storm
- Planning for the recovery

Economies have been going through cycles of growth and contraction for as long as economists have been around to study business activity, though in recent years the swings have been more violent and sustained that usual. For the most part, advanced economies such as the US and Europe grow on a steady upward trend of around 3 per cent a year, but sometimes growth stalls or even contracts and when that happens it has a knock on effect on demand throughout the economy. The more severe the contraction, the worse the effect.

If demand drops for a couple of quarters by a percentage point or two it signals a recession and large numbers of businesses will close. The bigger and longer the decline, the more you need to adapt your business plan to fit the economic climate. Depressions occur when the economic contraction is extremely severe and GDP declines by over 10 per cent. Depressions are almost invariably international, concerning many countries, and involve the collapse of financial markets in general and the banking system in particular. They are usually triggered by mistakes in economic policy.

Cycles and the Multiplier Effect

Expenditure *multiplies* through the economy. This means it has a far greater ripple effect than the initial sum involved, making spending activity more important than the sums themselves may sound. Suppose that the government, the country's largest single customer, decides to embark on a major programme of school building, resulting in $100 million of salaries for construction workers. The impact of their salaries on the economy depends on their *marginal propensity to consume* (MPC) – that is, how much of their salary they will save and how much they will spend. If we suppose that they will save 10 per cent of salary (the approximate twenty year average), then they will spend 90 per cent. That gives an MPC of 0.9, which is 90 per cent expressed as a decimal. The *spending multiplier* effect is expressed as the following formula:

$1 \div (1 - \text{MPC})$

which for our example is

$1 \div (1 - 0.9) = (1 \div 0.1) = 10$

So the effect $100 million of spending on the wider economy is 10 x $100 million, or $1,000 million because each 90 per cent of worker's income is spent, which in turn becomes someone else's income which they spend 90 per cent of and so on. In a recession, when spending declines, the effect is similarly magnified. Taking a $100 million of spending out of the economy will result in an overall decline of $1,000 million, and this decline can steepen if the MPC drops, as nervous consumers opt to increase saving and reduce expenditure.

Downturns galore

Recessions and instances of even more serious financial turbulence are more common than is generally known. However, like earthquakes, they usually happen somewhere else! According to the International Monetary Fund (IMF) there have been 124 *systemic* (general) bank crises since 1970, when bad debts devastated the economy and much of the banking sector was insolvent. The vast majority of these crises were in the developing world, in Asia in particular. Japan's slump following a property crash in the 1980s and Sweden's bank crisis in the 1990s are among the half dozen major crises to hit developed economies. These were followed by the world banking crash of 2008 and the Euro crisis of 2011, whose effects spread around the globe like wildfire and are still being felt.

Cycles are different

Alfred Marshall, the dominant figure in British economics until his death in 1924, defined economics in his influential textbook *Principles of Economics* as: 'a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of well-being. Thus it is on one side a study of wealth; and on the other, and more important side, a part of the study of man.' Today that definition has been shortened in most textbooks on the subject to: 'Economics is the social science which examines how people choose to use limited or scarce resources in attempting to satisfy their unlimited wants.'

The '*dismal science'*, as economics is often called reveals something of the contradictions inherent in the subject itself. Science to most people means the establishment of fundamental truths that hold good under all conditions and forever. 'Two and two equals four', works equally well as a proposition in Marlowand Mongolia. But put two economists together and you will get three economic theories or perhaps even four. That is certainly the case when it comes to the world of business cycles. These are anything but simple, and to make things more complicated still there is not one cycle but at least four that operate, each with different characteristics yet interacting one with the others.

Kondratieff's long waves

Nikolai Kondratieff (or Kondratiev), a Soviet economist who fell out with Russia's communist leaders and died in one of Stalin's prisons, advanced the theory that the advent of capitalism had created *long-wave* economic cycles lasting around 50 years. His theories received a boost when the great depression (1929–33) hit world economies and resonated in Britain in 1980–81 when factory closures, high unemployment and crippling inflation devastated the country. The idea of a long wave is supported by evidence that major enabling technologies from the first printing press to the Internet take 50 years to yield full value, before themselves being overtaken.

Kuznet's Cycle

American economist Simon Kuznet, a Nobel Laureate (1971) working in the University of Pennsylvania, made a lifelong study of economic cycles. He identified a cycle of 15–25 years duration covering the period it takes to acquire land, get the necessary permissions, build property and sell. Also known as the *building cycle*, this cycle has credibility as so much of economic life is influenced by property and the related purchases of furniture and associated professional charges for example for lawyers, architects and surveyors.

The Juglar Cycle

French economist Clement Juglar studied the rise and fall in interest rates and prices in the 1860s, observing boom and bust waves of 9 to 11 years going through four phases in each cycle – prosperity, where investors piled into new and exciting ventures; crisis, when business failures started to rise; liquidation, when investors pull out of markets; and recession, when the consequences of these failures begin to be felt in the wider economy in terms of job losses and reduced consumption.

The Kitchin Cycle

In 1923, Joseph Kitchin published in the Harvard University Press an article entitled 'Review of Economic Statistics', outlining his discovery of a 40-month cycle resulting from a study of US. and UK statistics from 1890 to 1922. He observed a natural cyclical path caused, he believed, by movements in inventories. When demand appeared to be stronger than it really was, companies built and carried too much inventory, leading people to overestimate likely future growth. When that higher growth failed to materialise, inventories were reduced, often sharply, so inflicting a 'boom, bust' pressure on the economy.

Anticipating trouble

Readers of earlier editions of this book would probably have thought a chapter like this was irrelevant. New Labour was commited to banishing boom and bust and the last serious downturn in the UK was in 1982 when national GDP declined by around 7 per cent over a period of some three years. Although since then there have been three recessions in the UK economy, all have been relatively mild and governments were inclined to attribute this 'great moderation' to clever policies. 2008 changed all that and most credible research indicates that government economic policies only have a modest effect on the business cycle.

So what are the tell-tale warning signs of trouble ahead? First the bad news. John Maynard Keynes, the great economist of the last depression era, described the cause of the violent and unpredictable nature of the business cycle as ‘animal spirits,’ or people’s tendency to let emotions, particularly swings from excessive optimism to excessive pessimism, influence their economic actions. No one has a great track record when it comes to forecasting recessions. The Wall Street anecdote has it that ‘The stock market has predicted nine of the last five recessions.’ Nevertheless, some facts about cycles are known:

- In recessions, demand in the economy is below the long-term trend for an average of 11 quarters.
- The cummulative fall in GDP over the recession averages 4 per cent.
- The average expansion where growth is above trend is around 11 quarters.
- Long-run average growth is around 2.8 per cent.

See Figure 15-1 for an outline of how business cycles work.

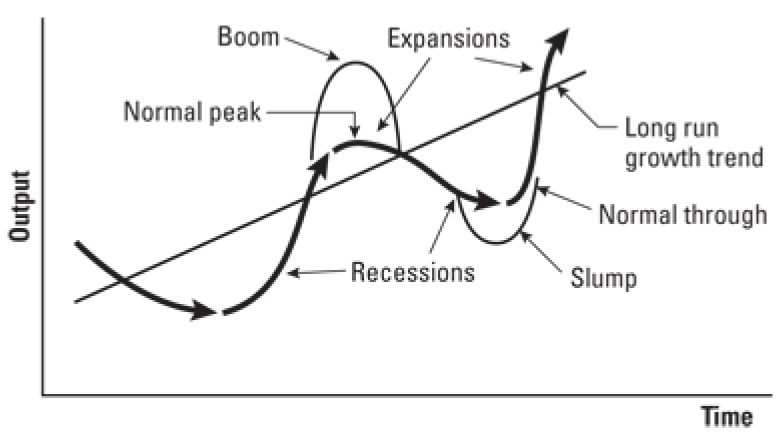


Figure 15-1: Business cycles: pattern and phases.

If the economy has been growing above trend for several years, there is a better than average chance that a recession is on the horizon and it is time to batten down the hatches.

Preparing for the Worst

The most dangerous phrase in economic forcasting is ‘this time it’s different’. Business cycles and occasional serious recessions are part of the long-term business environment. Joseph Schumpeter, another famous economist, describes the business cycle as ‘the economic ebb and flow that defines capitalism. He went on to conclude that business enterprises operate in ‘the perennial gale of creative destruction’. Not much comfort, but essential to know! These are some of the important steps to build into your business plan in turbulent times.

Deleveraging balance sheets

Leverage, or *gearing* as it is more usually termed in the UK, is the relationship between *debt* – that is, borrowed money that has to be paid back one day and carries an interest burden throughout its life – and *equity*, money put in by shareholders who hope to realise a long-term gain as the business prospers. (In Chapter 16, you will find a more detailed explanation of these financing methods). The higher the proportion of debt a business has as a proportion of its total finance, the higher the gearing.

Debt is so attractive to a business because its cost is finite and unrelated to the success of the venture. The 5 to 10 per cent interest paid to the bank for a loan doesn’t go up if the business itself makes a return of 10 to 20 per cent. It follows that the more you can borrow at a lower cost than the profit you can make, the better. In times of rapid growth – booms in particular – money is cheap, customer demand is high and it makes commercial sense to borrow. But when a recession hits, demand declines and highly geared businesses may not make sufficient profit to service the interest on their debt. Worse still, the banks may get nervous, or as they did in 2008–9, run out of money themselves. A recsssion, as one economist said, is a time when money returns to its rightful owners!

The general rule is that over the economic cycle a prudent business should have no more than £1 of debt for every £1 put up by the shareholders. Studies of the characteristics of companies that failed in recent UK recessions concluded that the majority had an above-average level of debt.

Containing working capital

Financing the day-to-day operations of a business, stock, customer credit and so forth is done using working capital, often provided by banks in the form of an overdraft. The amount of working capital required is heavily influenced by two factors:

- **The level of operating efficiency:** Make sure that production processes, stock levels and supply chain management are working optimally.
- **The credit control process:** Ensure that customers pay up and keep suppliers waiting for payment for as long as is commercially acceptable. In periods of economic growth, particularly during booms, control of working capital levels slacken off. Stocks are allowed to build up in the anticipation of continued sales growth and customers seeking to increase their orders are allowed even more credit.

The general rule with working capital is that it shouldn't exist at all in a well-run business. Current liabilities should match current assets so that no additional money is required. (If you are a little hazy on these terms, look back to Chapter 10). In reality, you will be unlikely to achieve such a perfect situation. However, anything over £2 of current assets for every £1 of current liabilities should be a warning sign that a degree of sloppiness is getting into your operations and needs urgent attention.

WARNING!

Thousands of businesses go bust during recessions and some of them may well be customers of yours. One of the top three reasons that businesses fail is because a customer fails to pay up in full or on time. You can access a wealth of information on the credit status of both individuals and businesses. The complexity of this information varies, and it comes at prices from £5 for basic information through to £200 for a very comprehensive picture of credit status. As a result, there is no need to trade unknowingly with individuals or businesses that pose a credit risk. The major agencies that compile and sell personal credit histories and small business information are Experian (www.UKexperian.com), Dun & Bradstreet (www.dnb.com), Creditgate.com (www.creditgate.com) and Credit Reporting (www.creditreporting.co.uk/b2b). Between them they offer a comprehensive range of credit reports instantly and online, including advice on credit limits.

Pricing under pressure

Price is the easiest and fastest element of the marketing mix to change. As a result, a great temptation exists to drop prices when the pressure is on. Consider the following when you're thinking of dropping prices:

- Price and quality are closely associated, so if you drop your prices faster and further than your competitors, your customers may suspect that standards are dropping. There is, after all, a strong belief that you only get what you pay for.
- You have to sell an awful lot more of a discounted product to make the same amount of profit. Look at the Table 15-1 below. This shows that in order to make the same amount of gross profit, a business discounting by 20 per cent would have to sell 67 per cent more product. The logic is simple. Unless you can get your suppliers to share some of the pain and reduce their prices too, your gross profit will drop by the amount of your discount.

Table 15-1 The True Cost of Discounting

Selling Price	*Volume Sold*	*Gross Profit Per Unit Sold*	*Total Gross Profit*
£100	100	£50	£50,000
£80	100	£30	£30,000
£80	167	£30	£50,000

The best strategy is to defend your selling price by emphasising the value of your proposition against that of your competitors. If necessary, add in some non-price elements such as 'one free for every ten ordered'. Where you absolutely have to give way on price, do so selectively, and only where you can trade that discount for an equally valuable concession from a customer. Examples of such concessions include faster payment terms, increased volumes and exclusive supply agreements or a long-term contract.

Maintaining market share

In Chapter 8, we explained the importance of relative market share to a business's capacity to make profit. To summarise quickly, the more experience you have of making or doing something the better you get at it, which in turn translates into lower costs. In a major downturn, total demand drops, sometimes sharply, but if you can maintain your share of that smaller market your relative position is unchanged. (See Table 15-2.) That may not seem much of a victory, but it does mean that your cost advantage is unimpaired and can be used to your advantage when market conditions improve.

Table 15-2 Maintaining Market Share

Market Players	*Volume Sold Last Year*	*Market Share*	*Target Volume When Total Market Contracts by 25 Per Cent*	*Market Share*
Me	200	50%	150	50%
XYZ Co	100	25%	75	25%
MYX Co	100	25%	75	25%
Total Market	400	100%	300	100%

Conserving cash

In turbulent times, there is no doubt that cash is king. The old saying 'turnover is vanity and cash flow is sanity' is worth dusting down in these times. It is also an unwelcome fact that banks can prove less than reliable when the going gets tough. That description of a bank manager as someone who lends you an umbrella and then asks for it back as soon as it looks like raining has an all too familiar ring.

So what steps should you take to keep cash in your business? Consider the following options:

- **Eliminate all expenditure that is not essential to your core business for the next 6 to 18 months.** You can keep this under review on a rolling basis.
- **If possible, turn short-term loans such as overdrafts into longer-term loans.** These are less vulnerable to the whims (and panics) that bankers are prone to when the economy turns sour.
- **Provide bonus and incentive payments in the form of shares rather than cash.** This has the added benefit of getting employees more committed to the business's capacity to generate profit – and to survive. If the business doesn't survive, their bonus will be worthless.
- **Get an investor to share the risk.** You may be nervous about the idea of giving an outsider a stake in your success, but a downturn is a timely reminder that investors share the pain as well as the gain. In Chapter 10, we looked at the sources of share capital and now could be a good time to thumb back there.

Keeping key employees

Downsizing is for most organisations a largely reactive strategy initiated during a cyclical business downturn. Although it is the strategy of choice in tough times, there is not much evidence that it is very effective. Research suggests that the cost savings are almost invariably eroded by the loss in productivity caused by the low morale of the survivors. Worse still is the tendency for the best people to jump ship early and leave the organisation to struggle on playing with the second eleven. Steps you can take to keep the best people with you include:

- Reassure them quickly and frequently about their value and position in the organisation.
- If you do have to downsize, cut once and cut deep. Death by a thousand cuts is a sure-fire recipe for killing corporate morale.
- Consider providing key staff with a survival bonus, payable only when the general economy recovers.
- Look for imaginative and compassionate strategies for cutting employee costs, including offering extended holidays, sabbaticals, short-time working, for example. Key staff will be observing how you treat those most affected by your cost reduction plans to get a measure of how you will behave towards them should their time come.

Selling off assets

In the spring of 2009, nearly every bank in the world was selling off any part of their business that was not core. The Royal Bank of Scotland put a fifth of its assets into a separate business ready to be sold off, leaving the management free to concentrate on the part that might possibly have a future. A decade earlier, in September 1999, to be precise, Unilever announced its intention to focus on fewer, stronger brands in order to 'promote faster growth and improved margins'. That was their reaction to turbulent market conditions. Over the following four years, Unilever set out to whittle its brands down to just 400 from the 1,600 it started out with. At the same time it shook up its top management, splitting the company into two separate global units, 'Food and Home' and 'Personal Care'.

Two main rules exist when it comes to asset sales:

- **Sell off quickly.** Research shows that distressed sellers, that is those that leave things so late they have no other options get 20 per cent less for near identical assets sold by stronger companies over the same period.
- **Have no sacred cows.** Any asset that is not both central to your core business and generating positive cash flow should be considered as saleable. Disposing of them will give you the cash to sustain and develop your main long-term business.

Preparing for the Upturn

So much for surviving the downturn phase of an economic cycle. Fortune favours the prepared mind. Look back to Figure 15-1. Just after the curved line crosses the long-term trend line heading south is the time when you need your plans for the upturn to be taking shape.

How should you begin? Start by rereading this book. (Just kidding.) Actually, you can start by thinking about the same sorts of questions that we've raised all through the book, but with the current economic climate in view. In particular, consider these questions:

- What should the company's mission and vision be now?
- Does what we are offering still satisfy the customers' needs?
- Who are our competitors now?
- What are the company's critical success factors?
- Where is the company's competitive advantage?

- What is the company's strategy for success?
- What resources – people, facilities and cash – do we need to deliver such strategies?
- Should I be getting ready to sell up as the best value is to be had towards the top of the next upturn?

Acquiring competitors

There have been some 60 studies conducted into the success or otherwise of acquisition strategies since Kitching's seminal work 'Why do mergers miscarry?' published in a 1967 edition of the *Harvard Business Review*. All concluded that at best, acquisitions added little value, more usually they destroyed value and at worst they destroyed both the acquirer and the acquired. Over half of all acquisitions are divested within a decade and studies show that there has been a big question mark over the subject of acquisitions and the non-acquiring firms, that is those that steered clear of this type of strategy, matched or out-performed acquiring firms by a margin of two to one.

So by now you may have concluded that we must be off our heads to recommend such an obviously duff strategy to readers smart enough to have picked up a book like this. Bear with us for a moment. Think back to why most big acquisitions happen. They are usually clashes of titans with more ego than economics entering into the equation. Targets (those companies being acquired) dig their heels in and stick out for a high price. Hunters (those doing the acquiring) want to win, often at any price. Time Warner's acquisition of AOL and Skype's of eBay spring to mind here. But in turbulent times, targets are in no position to be greedy and hunters simply can't overpay as the dosh just isn't there.

A study of 1,000 mainly industrial US companies over the period 1982–99 that straddled the US recession of 1990–1 concluded that the most successful companies made two thirds fewer acquisitions during the expansion stage of the economic cycle than their less successful competitors. But during the recession, while their peers sat on their hands, the best performing companies went on a buying spree. In the process, they grew market share, improved their relative costs and did deals that added value and often reshaped markets.

So if you have the cash and can find a business that will strengthen your core proposition or add market share, this could be the time when fortune favours the bold.

Planning short term for the long term

The most turbulent stages in the economic climate are usually clustered around the slump and boom stages (See Figure 15-1 above). These are times when the whole idea of having a long-term business plan outlining strategies for several years ahead may seem frankly little more than wishful thinking. However, a business needs a strategy and strategy takes a period of time, usually months and often years for its success or otherwise to become apparent. Motor companies, for example, who were hit hard by the 2007–9 slump could hardly hope to survive – let alone tap into government support – without a long-term plan. That plan involved developing, producing, marketing and supporting ranges of new and more environmentally friendly vehicles – hardly the kind of activities that could be accomplished in a few weeks or months.

Rolling quarterly plans

Step forward the short-term, long-term planner's most useful tool, the rolling quarterly forecast. Say your three-year business plan shows sales growing from 100 to 155 units over a three-year period broken down into twelve quarterly targets. (See Table 15-3 below.)

Table 15-3	The Rolling Quarterly Business Plan												
	Q1	*Q2*	*Q3*	*Q4*	*Q5*	*Q6*	*Q7*	*Q8*	*Q9*	*Q10*	*Q11*	*Q12*	*Q1*
Sales objective	100	105	110	115	120	125	130	135	140	145	150	155	
Sales actual	90												
Revised sales objective		95	100	105	110	115	120	130	135	140	145	150	155

The initial sales objectives underpinning the business plan calls for a growing trend rising from 100 in Quarter 1 to 155 by Quarter 12, the end of the three-year planning horizon. By the end of the first quarter, with sales falling well short of plan and the economy in freefall, it would make sound sense to revisit the plan and make sure that goals are realistic, believable and attainable. In seriously turbulent conditions, you may decide that the best plan is to revise downwards the sales objectives for a few quarters with a view to catching up lost ground in later quarters. By adding a new quarter as each period ends, you can keep a permanent three-year planning horizon. Then as slump turns to boom, you can quickly revise upwards your whole business plan.

Speeding up the information flow

Running a rolling quarterly business planning system calls for reliable, timely information. You need to know exactly what products and services have sold and in what quantities. You also need the latest information on markets and competitors so that you can make useful future projections. If, for example, you know nothing more about the business environment at the end of the first quarter than you did at the outset, except that you have failed to meet your objective, then your future plans will be as unreliable as your past ones. Look again at Chapters 4 to 7 to get some ideas on the information flow essential to keeping your plan up-to-date.

Accelerating response rates

As well as timely information, you must have contingency plans ready to respond to possible major events. Suppose that your business plan is prepared on the assumption that the economy will contract by 10 per cent over the first year of your plan. But it turns out that the government's stimulus package is more effective than anyone could have hoped or expected. So rather than slump by 10 per cent, the economy booms by 10 per cent. If you have that as a possible scenario and a plan in place to deal with it – to rope in more staff, plug in an extra shift, bolt on some additional warehouse space and so forth – then if things turn out that way, you can be ready to move. Having a number of such scenarios makes it easier to speedily exploit changes, while slower-thinking competitors are still blinking in shock.

Chapter 16

Making Your Business Plan Work

In This Chapter

- Examining your business plan
- Putting together an organisation that works
- Developing procedures and systems
- Encouraging leadership roles
- Developing necessary business skills
- Creating your company culture

Congratulations – you're close to completing your business plan! As much as we'd like to help you finish, we're not going to stand over your shoulder right now. Just remember that you've already done the really hard parts; at this point, you need to bring them together. If you need a little nudge to get under way, flip to Chapter 1 for a sketch of what your written plan should look like, or check out Chapter 17 for a good example of someone else's business plan.

Unfortunately, you don't have much time to celebrate a job well done. Did you ever hear the story about the man who fell off a 20-storey building? As he passed the fifth floor, he shouted, 'So far, so good!'

Clearly, that man wasn't thinking his situation all the way through. Too many companies are guilty of the same optimism when it comes to business plans; they fail to see how critical (and sometimes difficult) it can be to actually carry out a completed plan. More than a few of these companies ultimately self-destruct – not because they don't have a business plan, but because they assume that when the plan is finished, everything else will simply take care of itself. Preparing for what comes next, after your own plan is on paper, is important. You need to do more than just make your business plan; you also have to make it work.

In this chapter, we help you understand what you need to do to carry out your business plan. We show you ways to shape your company and prepare your people, using your business plan as your primary guide. We explore how you can create an effective organisation and then come up with business procedures that promote the goals and objectives in your plan. Finally, we talk about how you can encourage the people around you to take on leadership roles, develop the skills that they need and create a strong company culture to make your business plan a reality.

Shaping Your Company

When your business plan is ready, you need to take the next step, which means carefully arranging all your company's resources to put the plan into action. If you were designing a chair, a desk or a sofa, rather than your company, you'd probably be reminded of the adage:

> *Form follows function.*

This saying is really why chairs look the way they do – and look different from sofas. The function of your company is set out in your business plan, and you need to design a form for your company to support that function.

For decades, business consultants have made their names and fortunes by coming up with different ways to design companies and organisations. What a surprise! We're quite sure that any number of these consultants would be happy to tailor a design just for you. But before you call one of them (and sign a big fat cheque), you may want to see what you can put together on your own. Then, if you decide that you really do need professional help, you know the right questions to ask.

As you come up with ways to design your company, you need to consider the six major areas shown in Figure 16-1. Three of these areas shape your company; the other three prepare the people around you.

Living the plan

When you have your business plan down on paper, take the time to read it – and we mean *really* read it. Don't just check for typos and bad grammar; remind yourself of what it actually says. An amazing number of companies have business plans that nobody reads. At least, nobody in those companies seems to know much about what the plans say (other than the all-important numbers in the budget, of course).

Figure 16-1: The six major areas of your business that make a business plan work can be divided into two groups.

Perhaps you feel that there's nothing you don't already know about your own business plan. Because you're so close to all parts of it, however, you can sometimes forget the big picture. So step back and pay special attention to the broad sweep, below:

- Read your company's mission and vision statements as though you were seeing them for the first time.
- Consider the goals and objectives that you set for your company, and ponder what they really mean.
- Review the strengths and weaknesses that you identify, and consider what they say about your company's capability to make the plan work.
- Think about the different ways in which your company provides value to its customers and how these ways add up to your long-term advantage.

If you expect everyone who's involved in your company to take the business plan seriously, you need to start with yourself. As you put your business plan into practice, stop and take a step back on a regular basis. Ask yourself these sorts of questions:

- Do the procedures that you come up with make sense in terms of the kind of organisation that you're creating?
- Does your leadership promote the sort of company culture that you'd like to see?
- Does the shape of your organisation encourage the skills that you need your employees to have?
- Do the procedures that you put in place make your company culture stronger and more focused?
- Do the skills that you emphasise add to the leadership qualities that you want to develop?
- Does every last thing that you do support the business plan that you're working toward?

Growing fast is hard to do

GEC was a red-hot company in the 1970s. The company was built up by a series of acquisitions by the legendary Arnold (Lord) Weinstock.

Weinstock ran a tight ship, some say too tight. After a couple of decades of buying up most of the UK's electronics industry, he sat tight, running the empire using a grid of a handful of accounting ratios. A summary of these ratios for every business was in his office each month, and any executive not up to the mark followed close behind.

When he retired, his successor George Simpson (Lord Simpson of Dunfeld), a man of undoubted energy and passion, changed strategic direction overnight, going hell for leather for growth. Seduced by the

Internet bubble, he sold off GEC's famous defence business and other segments of the old conglomerate, and bought heavily into telecoms companies around the world just as the sector was going into massive over-capacity. Simpson delighted in his selling and spending spree, declaring that he intended to reduce Weinstock's carefully stewarded assets 'as fast as I can'. To be absolutely fair he was, in part, reacting to the decades of criticism Lord Weinstock had had to suffer for sitting on his cash and buying nothing. As 2001 began, the newly renamed Marconi had 11 new companies in its stable, and an untried Oracle e-business system, to replace Weinstock's handful of hand-produced key ratios, to manage all the financial details together.

The system failed to work as expected, and the board lost track of the dismal performance of the new businesses. From a peak of £12, the shares fell to less than 4p. Simpson and John Mayo, Marconi's finance director, walked the plank, and under new management the group secured a debt-for-equity swap that shifted control to creditors, leaving shareholders with just 0.5 per cent of the business.

In barely nine months from the end of 2000, the once powerful Marconi, formerly GEC, lost 95 per cent of its market value. From a £4 billion cash mountain built up by Lord Weinstock, it had heaped up the same amount of debt.

Looking back, you can easily see what went wrong:

- The company's management didn't really understand the new business sectors they were going into.
- Their business systems were not up to running the newly acquired companies.
- They got their timing spectacularly wrong, entering sectors in their death throes.

Now, under Mike Parton, the business is slowly recovering, but is a mere shadow of the empire it once was.

Putting together an organisation

If everybody in your company can fit comfortably into a Honda hatchback, you're going to have a fairly easy time coming up with an organisational structure; you can arrange two or three people in only so many ways. But the mere fact that a structure is straightforward doesn't mean that it's not important. Whether you've 2 or 2,000 employees, the way that you design your organisation plays a major part in your success in making your business plan work. No matter how big or small your company gets, everybody in it still needs to know what her job is. All employees have to understand the special roles that they play in carrying out the business plan and in achieving company goals and objectives.

Where do you start? You can put together an organisation in several ways. The following sections discuss several of the most common structures.

Basic design

The simplest way to organise your company is to put somebody at the top – an owner or senior manager – and let everybody else do all the jobs that have to be done. Describing how everyone fits in is easy, because everybody's equal to everybody else.

- **Advantages:** You can usually find someone who's willing to do a job whenever it needs to be done. Because you're not devoting many extra resources to managing the organisation itself, the basic design is cost-effective, too.

- **Disadvantages:** The basic design really works only if your company has fewer than about 20 people. If the company is any larger, the person at the top can't keep track of everybody. So if your company is growing, at some point you're bound to outgrow your organisation. The basic design isn't always efficient, either. People end up doing jobs that they've never done before, and experience often gets lost in the shuffle.

Functional model

If you organise your company around business functions, you divide people into groups, depending on what they do. You take all the engineers and put them together in one area, and lump the marketing types together in another area. You put the operations people together in one group and all the financial folks in another. You need to make sure that some sort of general manager coordinates the various activities of the functional groups, of course. Some advantages and disadvantages exist to the functional model:

- **Advantages:** A functional organisation works well if your business involves only one type of product or service. The organisation is efficient, because people get really good at their particular tasks and each function performed is done only in one place. Also, everybody knows exactly what she is responsible for. The jobs in your company are well defined, and you've a clear-cut way to measure how everyone's doing.

- **Disadvantages:** Unfortunately, a functional organisation can too easily turn into a bunch of separate boxes stacked on top of one another. Each box houses a different functional area; the boxes aren't connected well, and without good communication, the functions begin to have separate goals. Operations, for example, wants to make the same product over and over, whereas Marketing wants to sell different products to different customers. Each function may be efficient by itself, but both functions taken together aren't terribly flexible or effective in carrying out a larger business plan.

Divisional form

If your company is big enough to be in more than one business, the best approach may be to organise by divisions. Each of your company's divisions may be responsible for a particular product, a market or a geographic area. If your company is even bigger, your divisions may cover strategic business units, or *SBUs,* which are specific product-market combinations. (Refer to Chapter 14 for additional information on SBUs.) Usually, the major divisions in your company are divided up further, often into separate business functions within each area. Check out the advantages and disadvantages to the divisional form:

- **Advantages:** An organisation made up of divisions that are based on products, markets, or SBUs encourages your company to focus all its energy and resources on the real businesses that you're in. Senior managers can tend to the larger issues of how the divisions work together. Managers inside the divisions can concentrate on their own sets of customers, competitors and company issues.

- **Disadvantages:** Because the separate divisions within your company often represent entire businesses, they sometimes compete with one another, perhaps going so far as to fight over the same customers. Also, separate divisions usually mean additional overhead costs, because each division invariably has its own set of management layers and business functions (research, operations, marketing, service, sales and finance) that are bound to overlap. As a result, ultimately your company is less efficient and less capable of taking advantage of any economies that result from combining tasks.

Matrix format

The matrix format organises people along two dimensions, rather than just one. In a matrix organisation, everybody has two bosses and wears two hats. One hat may be functional; a person may be in the programming or auditing group, for example. The other hat may relate to special projects, such as one that needs a programmer and an auditor for six months. In this case, the programmer and the auditor report to both a functional manager and a project manager. Bear the following in mind when considering the matrix format:

- **Advantages:** The matrix format allows you to share talent, expertise and experience among different parts of your company to see that these resources are applied when and where they're needed. A matrix organisation can be quite flexible in responding to business needs. At the same time, you maintain some of the efficiencies that you gain from arranging people by functions.
- **Disadvantages:** A matrix organisation can be tricky to manage – and sometimes even disastrous. The format violates an important management rule: don't give people two bosses at one time. Tension is bound to occur between the project manager and the functional manager, for example, and your people will be caught in the middle. If you're not careful, the matrix format can

lead to opposing priorities, clashing goals and diverging ideas about how your company's business plan should be carried out.

Your own way

After you decide *how* to organise your company, you have to decide *how much* you want to divide it up. Ask yourself a simple question: if the guy who mails letters has a suggestion to make, how many people do you want the suggestion to go through before it gets to the top of the organisation? In other words, how many management levels do you want to have?

The number of tiers in your management cake depends a great deal on how big your company is and how you organise it. Managers can manage only so many people directly if they want to do a good job, and certain organisational structures simply require more managers than others do. Always keep in mind one general rule. The more management levels you've in place:

- The more control is concentrated at the top of your company.
- The less flexible your organisation is in the face of change.
- The more costly your organisation is to maintain.

How do you know what kind of organisation – and how much of it – is right for you? Unfortunately, the answer isn't always obvious. Depending on your company's size, how fast the company is changing and the nature of your competition, certain ways of organising seem to have an edge over others. The ones that work best in practice seem to be the ones that combine aspects of several of the common options described in the preceding sections.

Some companies try to stay efficient, flexible and on target by keeping their organisations as simple as possible, using informal project teams when necessary and reorganising whenever changes in their industries and markets require it. A simple organisational structure tends to keep costs under control. Informal, temporary project teams create much of the flexibility of the matrix format without all the management confusion. Willingness to reorganise when things change can be a real strength, if you reorganise in the right way and for the right reasons.

Why do small companies stumble so often? A major stumbling block turns out to be an unwillingness on the part of people at the top to change the organisation as a small company grows bigger. Small companies tend to organise around a basic design, in which the owners or senior managers have their fingers in everything that the company does. Bigger companies just won’t work that way for long, and if the owners can’t let go when reorganising is necessary, the situation usually spells failure for an otherwise healthy enterprise.

Be sure to explore all your options as you go about creating or recreating your organisation. Try to come up with a structure for your company that makes sense to you. Only then can you put together an organisation that allows your company to work better and makes it easier for the company to fulfil its business plan.

Developing procedures

After you spend the time and effort to put together a business plan, you may naturally assume that running your business will automatically be easier. If your company's small, you may not have given any serious thought to what comes next. Now that you know what you have to do, you just go out and do it, right? Whether making a sale, negotiating with a supplier, or keeping track of expenses, you just get the job done, even if you have to change the procedure (or make up a new one).

Informal procedures such as these (especially the ones that always change) don't work for long, however, even if your company's just you. Your customers want to know what to expect when they deal with you, no matter how big or small your company is, and so do your suppliers. (So do the tax people, for that matter.) Nobody likes to deal with lots of rules and regulations, unless they're in the army. But all companies eventually have to come to terms with the set of guidelines that they're going to use to remind everybody how they're supposed to operate.

When you start thinking about the procedures that you use to get things done in your company, you keep discovering new ones. To start, ask yourself how your company does the following things:

- Keeps track of customer sales orders.
- Manages credit control.
- Manages its cash flow and bank accounts.
- Invoices and credits customers.
- Handles customer complaints.
- Recruits and trains new employees.
- Determines wages, salaries and benefits.

- Reimburses employee expenses.
- Develops capital and operating budgets.
- Manages product inventory.
- Creates new products and services.
- Monitors the industry and the competition.

And don’t forget business-planning procedures. For years, managers and management gurus alike pretty much ignored the systems and procedures that made companies run. Face it – systems and procedures are b-o-r-i-n-g. As a result, many of the standard operating procedures across industries were thought up decades ago, at a time when business meant manufacturing, distributing and selling products. Period. But the times have changed – and companies have changed with them.

JARGON ALERT

During the late 1980s, businesses began to wake up to the fact that some of these boring old systems were holding them back. Enter *re-engineering* – the smart idea that you should take a close look at all of your company’s procedures to see whether they really make sense, given what your company actually does. When companies jumped on the re-engineering bandwagon, they discovered that they were doing all sorts of things just because they’d always been done that way. Today, doing things the same old way is simply not good enough, especially when your competitors are breathing down your neck.

Try to take the basic idea of re-engineering to heart when you develop your own business procedures. Do things in your company because they make sense, not because that's just the way things are or the way they were in your last company. Take a moment to think about a few of the essential systems that you're most likely to need as you go forward:

- **Accounting system:** The right accounting methods, principles and even software can mean the difference between really knowing what you have and losing track of where your money is coming from and where it's going. Profit & Loss Accounts, cash-flow statements and balance sheets are indispen-sable to your business. (Turn to Chapter 10 for all the financial information that you'll ever want.) You have to have a reliable accounting system in place if you want to be able to put your financial records together in a way that you can trust.
- **Budgeting system:** You need to develop procedures that allow you to create a complete financial picture today, as well as project your future needs (refer to Chapter 11 for more on financial planning and budgeting). You should make sure that your budgeting process covers your short-term needs, but, just as importantly, make sure that the budgeting system encourages long-term investments.
- **Human Resources system:** People are a big part of your company, even if you're the only employee right now. No matter how many people you count in your company, you should have a system in place that rewards employees for their hard work and also encourages them to think about their continued contributions over the long haul.

- **Information systems:** There's no quick-and-dirty way to keep up with what's going on in your industry and markets; you need to have a process to capture information when and where available. You also need an information system to make sense out of the information that you capture. Consider your customers. You should keep track of everything that you know about what customers want, what you've done for them in the past, and what they expect from you in the future. While you're at it, set up a similar system to keep track of your competitors.
- **Planning system:** We spent this entire book talking about business plans. But all the great planning ideas that you come up with may as well remain in your head if you don't set up a system to develop them inside your own company. Once you've a business plan, you also have to put a planning process in place to keep the plan alive.

Bear the following points about procedures and systems in mind:

REMEMBER

- As you put your plan into practice, make sure that your organisation, procedures and people all work together toward the same goals.
- How you organise – by function, product, market, or division, for example – plays a big role in making your plan work.
- With more management levels in place, you gain control but lose flexibility as a company.

- Be ready to change the way that your company is organised as the company grows or business circumstances change.
- Don't say, 'That's just the way things are done.' Make sure that every procedure you adopt makes good business sense.

Preparing Your People

What makes up your company, anyway? Maybe you think of your company mainly in terms of the products that you offer or the services that you provide. Maybe the image that first comes to mind is of a building or a warehouse with your name and logo on top. Perhaps you think of the organisation, your way of doing business and the reputation that you've tried to cultivate.

Your business really is all these things put together, and more. Ultimately, your company is defined by the people around you – who they are, how they act and what they're capable of doing. If you want your company to be successful, you have to figure out how to encourage leadership roles at the top. You have to make sure that the people around you develop all the skills that they need to do their jobs better. Finally, you must create a company culture that promotes your business plan and ensures that it gets accomplished.

Encouraging leadership

If you want the people around you to follow you into the future that you lay out in your business plan, you have to lead them there. But what does it really mean to be a leader, and how can you encourage others to take on leading roles?

We should be clear about one thing right from the start: leadership abilities and management skills are two different things. Leadership certainly is part of what it takes to be an exceptional manager. But leadership also describes a more general capacity to influence others and persuade them to behave in certain ways. The world has seen its share of political leaders and spiritual leaders, as well as business leaders.

Effective leaders lead in different ways, depending on the circumstances at hand. As you find yourself in different business situations, you have to be prepared to alter the way that you lead as well. Consider the following leadership styles:

- **The boss:** In certain situations, you have to tell people what to do, because they simply don't know how to proceed or because you've definite ideas about what has to happen next. Even while you're being the boss, however, remember that you're going to get the most out of people by giving them good reasons why they're being asked to do something.
- **The adviser:** If you want people around you to take on responsibility over time, you have to be prepared to let them go off and try to accomplish the tasks that you give them on their own. In your advisory role, timing is everything, because you need to develop a sixth sense for stepping in with support and giving just the right amount of advice. You should also develop procedures so that your people know how to ask for help when they know that they need it. Sometimes you lead best when you allow people to make mistakes, realising that they grow from the experience.
- **The colleague:** As you bring people into your company and develop strong working relationships over time, your leadership may become almost invisible. On the surface, you behave more like a colleague – one among

equals. In this case, you lead in subtle ways and often by example. If you demand the best of yourself, others excel, too. If you meet deadlines, others meet them, too. This brand of leadership is based on mutual respect, and it can turn into one of the most powerful forces and potent assets that you have in making your company work.

As you reflect on your own leadership talents and those of the people in your company who are closest to you, you may wonder whether leaders are born or whether they can be made. Which statement is true is hard to say, of course. Some people are natural leaders. It's certainly easier to think about how you train someone in basic management skills, for example, than how you go about instilling leadership abilities in them.

The Army claims that it can create leaders out of raw recruits. Although we may argue about its success rate, the Army has come up with leadership techniques, procedures and programmes, as well as with one simple piece of wisdom:

Don't ask those you lead to do anything you wouldn't be willing to do yourself.

Come to think of it, that's pretty good advice for aspiring leaders in any situation and in every walk of life.

Developing skills

At some point, you have to turn your attention to your employees, who are the ones who turn your business plan into reality. Employees can't be just any bunch of random people who are willing and able to work (not if you want your plan to work, that is). The people you bring on board must have the right skills to do the kinds of jobs that you ask them to do.

The right skills today are different than they were just 10 or 15 years ago. Oh, your people should still be top in their own areas, whether their areas are engineering or operations, marketing or sales. But they also need to have more general abilities that allow them to succeed in the company that you're putting together for the future. In many industries, the people around you must also excel in the following activities:

- **Managing information:** Employees should be able to deal with an avalanche of information on almost every imaginable aspect of your company. You need people who can not only organise the bits and pieces of data, but also make sense out of them and then go on to make business decisions that take advantage of the information.
- **Thinking independently:** Employees should be able to tackle and resolve business issues as they crop up. You can't afford to have people around you who do only what they're told to do. If you want to get the most out of your company, your people have to take initiative, think on their own and come up with answers to the business problems that they face every day.
- **Working in teams:** Employees should be able to get things done as part of a group. The need for speed in a complex business world makes it hard to get anything big accomplished without pooling resources, talent and expertise in a team. Whether you need to solve a technical problem, assemble a product or deal with a strategic issue, you count on a team of your people to get the job done.

- **Dealing with change:** Employees should be able to do things in different ways, take on new responsibilities and adapt to unfamiliar situations. Industries don't stand still anymore, and if your company is going to keep up, you need people around you who feel comfortable in a world in which the only constant is change.
- **Acquiring new skills:** Employees should be able to keep on growing. If you want your company to move forward, those around you have to be willing to move ahead as well. Your people have to take the time and make the effort to master new skills.

As your company grows and changes, you have to decide how your employees can acquire these skills. Do you invest in training to develop all the business skills that you need from inside your company, or do you go out and buy the necessary expertise, bringing in new people who already have the backgrounds that you're looking for? Going outside is certainly faster, but developing and promoting people from within your company can create a more dedicated work force and a much stronger organisation in the long run.

EXAMPLE

A leader on leadership

Jack Welch was the CEO of General Electric, one of the largest corporations in the world, with 1996 revenue of almost $80 billion and a work force 240,000 strong. Welch is a leader who understands the value of surrounding himself with other leaders. What does it take to be an effective leader at General Electric? According to Welch, leaders at GE have the following qualities:

- A passion for excellence

- Hate bureaucracy
- Are open to new ideas
- Self-confidence
- Involve everyone around them
- Enormous energy
- Energise other people
- Set aggressive goals
- Reward progress
- Understand commitment
- See change as being opportunity
- Know how to build diverse and global teams

Creating a culture

JARGON ALERT

Creating a culture in your company doesn't mean forcing everybody to go to the opera and symphony on a regular basis. Your *company culture* comes from the common attitudes, beliefs and behaviour of the people who are involved in your organisation. In that sense, company culture is a great deal like a nation's culture. But people aren't born working for your company, and they don't grow up in it either. When you attempt to create a company culture, you bring together people who have different backgrounds and try to give them a common outlook.

Your own company culture may focus on one or more of the following points of view:

- To offer the best technology around.
- To deliver the finest-quality products available.
- To provide the highest level of customer service.
- To be the most innovative company in the business.
- To have the lowest costs in the trade.
- To be the fastest-growing company in the industry.

You want these attitudes to translate into the way in which your employees act. If employees' behaviour is based on a set of shared beliefs, you can always count on the people around you to do the right thing in any business situation. Company rules and regulations look good on paper, but a company culture provides a sturdier set of guidelines for encouraging employees to behave the way that you think that they should.

Unfortunately, you can't order people to have a particular point of view, so you have to take advantage of less direct methods to change people's attitudes and influence their behaviour. Leadership has a powerful role to play in this task. The strongest company cultures often occur in companies that also have effective leaders – Virgin and Richard Branson, for example.

Some ways that you can use your own leadership skills to create a strong company culture:

- **Mission, values and vision:** Use your position in the company to talk about your company's mission, the values that you think are important, and the vision that you have for the business. Reinforce the things that really matter. Make sure that everybody is always aware of why you think that each person is a part of your company and what each person is ultimately supposed to accomplish.

- **Actions and activities:** Set an example for everyone around you to follow when it comes to the attitudes that you'd like to see and the behaviour that you'd like to promote. If you want your company culture to value customers, for example, go out and visit customers. If you want people to focus on profits, ask questions about profitability every chance you get. If innovation is critical to your company's success, search out the innovators, acknowledge them and reward them.
- **Rituals and rewards:** Set up rewards inside your organisation to support the company culture and the behaviour that you want to promote; then endorse and identify yourself with that behaviour. Offer customer-satisfaction awards, for example, and attend the ceremonies. Set profit targets, and hand out bonuses when they're met. Make a big deal out of innovations that work, and see to it that nothing bad happens when something new doesn't work out.

Your company culture can be one of the keys to making your business plan work. If you're not careful, however, it can also turn into a stumbling block. You can't change your company culture overnight, so you have to pay close attention to the attitudes and outlook of the people around you. You have to put in the time and effort that's required to encourage the shared behaviour that you expect to see across the company. Think about the following points:

- Leadership is the capacity to influence other people and persuade them to behave in certain ways.
- Different business situations demand different leadership styles.
- Choose people who can manage information, think independently, work in teams, deal with change and acquire new skills.
- Develop and promote people from within the company to foster dedication and a strong organisation.
- With a company culture that reflects your vision and values, you can always count on your people to do the right thing.

Building a team

Teams are the component parts of a businesses structure and their effective creation and operation are a key way to get exceptional results from an organisation. A group of people, even if they work together, are not necessarily a team. Look at Figure 16-2, which compares some of the characteristics of a sports team with those of a random collection of people that meet for a game. You can see immediately what needs to done to weld people into a team.

Figure 16-2: Why groups are not the same as teams.

Sports team

- Have the right number of players for the game
- Everyone has a cleary defined role
- Concrete and measurable objectives
- An obvious competitor for the team to unite against
- A coach to train and improve players' game
- Right equipment for the game

Sports club

- Just the number of people who turn up
- Positions of players decided on the day
- Often the aims have never been explained and where they have, different people have different aims
- Sometimes the internal competition is more important than winning a game
- Training is ad hoc
- The right equipment is sometimes missing and not all players have the right equipment

Successful teams have certain features in common:

- Strong and effective leadership.
- Clear objectives.
- Appropriate resources.
- The ability to communicate freely throughout the organization.
- The authority to act quickly on decisions.
- A good balance of team members.
- The ability to work collectively.
- A size appropriate to the task.

Rewarding results

While people often come to work for a set number of hours each week, what they do during that time is what matters most to the organisation. Different types of work have different measurable outcomes. Those outcomes have to be identified and a scale developed showing the base rate of pay and the additional payments above that base rate for achieving particular objectives. Different types of 'payment by results' schemes are in common use in different types of firm, and you need to carefully examine the conditions that most favour these types of pay to make sure that you pick the right mix of goals and rewards.

The ground rules in matching pay to performance are:

- Make the rules clear so that everyone knows how the reward system works.
- Make the goals specific, and if possible quantifiable.
- Make the reward visible so that everyone knows what each person or team gets.
- Make it matter. The reward has to be worthwhile and commensurate with the effort involved.
- Make it fair, so people believe that their reward is correctly calculated.
- Make it realistic. If the target is set too high, no one will try to achieve it.
- Make it happen quickly.

The following sections address specific reward systems.

Paying a commission

This reward system is perhaps the easiest to implement, but it really only works for those directly involved in selling. A *commission* is a payment based in some way on the value of sales secured by the individual or team concerned.

You have to make sure that the order is actually delivered or executed before any commission is paid, and you may even want to make sure that the customer has paid up. However, as with all rewards, you must keep the timescale between doing the work and getting the reward as short as possible, otherwise people forget what the money is for.

It makes sense to base the commission on your gross profit rather than sales turnover, or you may end up rewarding salespeople for generating unprofitable business.

Awarding bonuses

A *bonus* is a reward for successful performance, usually paid in a lump sum related as closely as possible to the results obtained by an individual, team, or the business as a whole. In general, bonuses are tied to results meaning that it can be less obvious how an individual contributed directly to the result achieved. For example, a company bonus may be paid out if the firm achieves a certain level of output. Keeping everyone informed as to how the firm is performing towards achieving that goal may well be motivational, but the exact role that, for example, a cleaner or office worker has in helping attain that goal is not easy to assess and not as easy to calculate as is a salesperson’s commission.

Bonuses can be paid out periodically or as a one-off payment for a specific achievement.

Sharing profits

Profit sharing involves giving a specific share of the company's profit to the firm's employees. The share of the profits can be different for different jobs, length of service or seniority.

This type of reward has the great merit of focusing everyone's attention on the firm's primary economic goal – making money. One or more employees can be performing well, while others drag down the overall performance. The theory is that the performing staff put pressure on the others to come up to the mark.

If profits go up, people get more; but it can go the other way too, which can be less attractive. Also, profit targets can be missed for reasons outside the employees' direct control. If you're dependent on customers or supplies from overseas, for example, and the exchange rate moves against you, profits, and hence profit-related pay, can dip sharply. However unfair this situation may seem to a employee who has been hoping for extra cash to pay for a holiday, it is the hard reality of business. If you think that your employees are adult enough to take that fact on board, then this method can be a useful way to reward staff.

Sharing ownership

Share option schemes give employees the chance to share in the increase in value of a company's shares as it grows and prospers.

The attraction of turning employees into shareholders is that it gives them a long-term stake in the business and hopefully makes them look beyond short-term issues and ensure their long-term loyalty. Of course, there can be unwelcome side effects if the value of the business goes down rather than up. Share schemes have important tax implications that need to be taken into account. You can find out all about these on the HM Revenue and Customs website (www.hmrc.gov.uk/shareschemes).

Assembling your finances

While having a great idea is an essential starting point in every business plan, money is the fuel that keeps a venture running. Even if you're launching a one-person freelance business, chances are you need cash to get off the ground. If you're starting a bigger company, and especially if you're founding a high-tech or manufacturing enterprise, chances are good that you need *lots* of cash and the faster you grow the more you need. These are the three sources that fund 99 per cent of all ventures and your business plan should say something about who you're going to tap for cash, when and for how much.

Piling on the debt

Debt is the general name given to money that is borrowed and that has at some point to be repaid and in the meantime you have to pay interest. Banks are the principle supplier, though you may have rich friends or relatives willing to step into the breach. The advantage of getting a loan is that you gain business funding while maintaining all the equity in your company. The disadvantage is that loan payments are due on schedule, even if your business runs into hard times.

The simplest bank-loan arrangements are:

- **Overdrafts:** An overdraft is an agreed level to which you can have a negative bank balance to allow you to cover peak periods of expense, for example stocking up for Christmas sales if you're in the toy business. Ideally, your bank account should be in credit at some point in the year. If not, the overdraft is becoming part of your permanent capital requirements and should be funded accordingly. The sting in the tail is that overdrafts are repayable on demand. With other forms of borrowing, as long as you stick to the terms and conditions, the loan is yours for the duration. Overdrafts are differnt as the bank can change the rules at any time.

- **Term Loans:** Term loans, as long-term bank borrowings are generally known, are funds provided by a bank for a number of years. The interest can be variable, changing with general interest rates, or fixed for a number of years ahead. The proportion of fixed-rate loans has increased from a third of all term loans to around half. In some cases, it may be possible to move between having a fixed interest rate and a variable one at certain intervals. It may even be possible to have a moratorium on interest payments for a short period, to give the business some breathing space. Provided the conditions of the loan are met in such matters as repayment, interest and security cover, the money is available for the period of the loan.

- **Enterprise Finance Guarantee scheme:** Operated by the banks at the behest of the UK government, this scheme is aimed at businesses with a turnover up to £25 million with viable business proposals that have tried and failed to obtain a conventional loan because of a lack of security. Loans are available for periods between 2 and 10 years on sums from £1,000 to £1 million.

  The government guarantees 75 per cent of the loan. In return for the guarantee, the borrower pays a premium of 1–2 per cent per year on the outstanding amount of the loan. The commercial aspects of the loan are matters between the borrower and the lender. You can find out more about the details of the scheme on the Business Link website (www.business link.gov.uk). Banks operating the scheme are listed on the Department for Business Innovation and Skills website (http://www.bis.gov.uk/ policies/enterprise-and-business-support/access-to-finance/enterprise-finance-guarantee/efg-list-of-lenders).

Raising venture capital

Venture capitalists (VCs) are investing other people's money, often from pension funds. They've a different agenda from that of business angels (see the next section), and are more likely to be interested in investing more money for a larger stake.

VCs go through a process known as *due diligence* before investing. This process involves a thorough examination of both the business and its owners. Past financial performance, the directors' track records and the business plan are all subjected to detailed scrutiny, usually by accountants and lawyers. Directors are then required to 'warrant' that they've provided *all* relevant information, under pain of financial penalties. The cost of this process has to be borne by the firm raising the money, but it will be paid out of the money raised, if that is any consolation.

In general, VCs expect their investment to have paid off within seven years, but they're hardened realists. Of every 10 investments they make, 2 are total write-offs, and 6 perform averagely well at best. So, the 1 or 2 stars in every 10 investments they make have to cover a lot of duds. VCs have a target rate of return of 30 per cent plus, to cover this poor hit rate.

Raising venture capital is not a cheap option and deals are not quick to arrange either. Six months is not unusual, and over a year has been known. Every VC includes a deal done in six weeks in its portfolio, but that truly is the exception. The British Venture Capital Association (www.bvca.co.uk) and the European Venture Capital Association (www.evca.com) both have online directories giving details of hundreds of venture capital providers.

Finding business angels

One likely first source of equity or risk capital is private individuals with their own funds, and perhaps some knowledge of your type of business. In return for a share in the business, such investors put in money at their own risk. They've been christened *business angels*, a term first coined to describe private wealthy individuals who back a play on Broadway or in London's West End.

Most angels are determined upon some involvement beyond merely signing a cheque and may hope play a part in your business is some way. They're hoping for big rewards – one angel who backed Sage with £10,000 in its first round of £250,000 financing saw his stake rise to £40 million.

These angels frequently operate through managed networks, usually on the Internet. In the UK dozens of networks exist, with thousands of business angels prepared to put up several billion pounds each year into new or small business.The British Business Angels Association (www.bbaa.org.uk) has an online directory of business angels in the UK. The European Business Angels Network (Eban) has directories of national business angel associations both inside and outside of Europe at www.eban.org, from which you can find individual business angels.

Floating on a stock market

Stock markets are the places where serious businesses raise serious money. You can raise anything from a few million to tens of billions, but expect the costs and efforts in getting listed to match those stellar figures. The basic idea is that owners sell shares in their businesses, which in effect brings in a whole raft of new 'owners' who in turn have a stake in the business's future profits. When they want out, they sell their shares on to other investors. The share price moves up and down to ensure that there are as many buyers as sellers at any one time. Going public also puts a stamp of respectability on you and your company. It enhances the status and credibility of your business, and enable you to borrow more against the 'security' provided by your new shareholders, should you so wish. Your shares also provide an attractive way to retain and motivate key staff.

Junior markets are an attractive proposition for entrepreneurs seeking equity capital. AIM is particularly attractive to any dynamic company of any size, age or business sector that has rapid growth in mind. The smallest firm on AIM entered to raise less than £1 million and the largest raised over £500 million.

As with the major stock markets, these junior versions expect something in return. The formalities for floating are minimal but the costs of entry are high, and you must have a nominated adviser such as a major accountancy firm, stockbroker or banker. The cost of floating on the junior market is around 6.5 per cent of all funds raised, and companies valued at less than £2 million can expect to shell out a quarter of funds raised in costs alone. The market is regulated by the London Stock Exchange. You can find out more by going to their website (www.londonstockexchange.com) and clicking on 'AIM'.

One rung down from AIM is PLUS-Quoted Market, whose roots lie in the market formerly known as Ofex. It began life in November 2004 and was granted Recognised Investment Exchange (RIE) status by the Financial Services Authority (FSA) in 2007. Aimed at smaller companies wanting to raise up to £10 million, it draws on a pool of capital primarily from private investors. The market is regulated, but requirements are not as stringent as those of AIM or the main market and the costs of flotation and ongoing costs are lower. Keycom used this market to raise £4.4 million in September 2008 to buy out a competitor to give them a combined contract to provide broadband access to 40,000 student rooms in UK universities. A total of 174 companies are quoted on PLUS with a combined market capitalisation of £2.3 billion. Even in 2009, a particularly bad year for stock market activity, 30 companies applied for entry to PLUS and 18 were admitted. You can find out more about PLUS at www.plusmarketsgroup.com.

Planning for the exit

When you're right in the middle of starting, growing or re-energising your company, hatching a plan for how to exit stage right may not seem top of your agenda. But it needs to be in almost from the start.

An exit strategy is a plan for how you and your fellow owners will leave the business at some point in the future, hopefully making a healthy profit in the process. Closing up shop is one option, but short of liquidating business assets, closing reaps no value from the business you've built. That's why business plans – even for start-up enterprises – should include strategies for someday selling, merging or transitioning the company in some way to new owners when the time is right for the founder to retire or move on to other ventures. Look back to Chapter 14 where we covered buying out competitors, this time putting yourself in the other guy's shoes.

Knowing where your business is headed and how you may someday exit is a crucial part of an effective long-term plan. By planning your exit early on, you put yourself in a position to steer your business towards your desired outcome.

Businesses seeking investors with deep pockets full of upfront cash have double the need for an exit strategy. An investor on the outside who's willing to put money into a company wants to know how she'll get it back – along with a handsome return on her investment. Unless you've a convincing exit strategy that describes exactly how you plan to make that happen, attracting serious investors is an uphill battle. Even if you're starting a company simply to be in business – with no idea of selling or turning your business over to others when you retire – you should still take time to think about what you're creating as you put your company together. You just may be creating something that has lasting value, even after you want to call it quits. Maybe you're creating a brand name that people recognise. Perhaps you'll attract a group of loyal customers. Maybe your network of contacts or your relationships with suppliers will have real value to someone else. If and when the time comes to close up shop, you should be aware of the intrinsic value of what you own. Don't simply throw it away.

Whatever kind of business you're in, ask yourself four basic questions:

- What are my reasons for going into business in the first place?

- How long do I plan to stay in business?
- What do I hope to end up with when its time to move on?
- Who may be interested in buying a business like mine – suppliers, competitors (actual and potential), family, friends and so forth – and why?

Chapter 17

Learning from Others: A Sample Business Plan

In This Chapter

- Viewing a sample business plan
- Following a business-plan template
- Learning about the tourism industry

Sometimes, you have to see something up close and personal before you really understand what it's all about. Viewing a real live business plan should get you much closer to putting your own plan down on paper.

> Your written business plan says something about all the important parts of your company. After all, you want to convince people – and yourself – that your company knows what it's doing. If you want to persuade people of anything, however, they have to actually sit down and read what's in front of them. So you want to be clear, concise and to the point, and it doesn't hurt to spend some time with your prose, either.

In this chapter, we show you a sample business plan. (We changed the names and some of the numbers to protect the innocent.) By reviewing the plan in some detail, you can discover a bit about how to construct a business plan of your own, and as a bonus, you can pick up some tips on the tourism industry. But please don't rely on any of the data; we provide it simply to illustrate the business plan and not to help you kick start your way into the tourism business.

There is no such thing as a universal business plan but you can use the table of contents below as a rough guide as to what to put into into your own business plan, as a sort of template. But every business is different as is the situation the business is planning for.

Safari Europe: Business Plan

Prepared in July 2009

By Karen Kehoe

Contact Details: Mob: 009912244: Email: kk@safari.com: Website: `www.safarieurope.org`

Business Plan Contents

Forecasts and Financial Data

Sales Forecast

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Appendix: Market Research

Safari Europe: Business Plan

~ Executive Summary ~

For the past five years Karen Kehoe has been a founder director of a very successful outdoor clothing shop in Bristol: Adventure Works. Last year that business made £120,000 profit on sales of £850,000 and employed seven people.

Adventure Works recently took on an agency from European Adventure Holidays, one of the largest and most respected tour operators in the market. With virtually no marketing effort some 200 adventure holidays have been sold by Karen in the past six months, netting £40,000 in commissions. Sales of insurance policies and other services have added to this total, and could potentially add much more. From desk and field market research carried out on 300 clients, Karen is certain that there is considerable potential in the adventure travel business. In particular one important segment of that market, the professional 25- to 35-year-olds who want to adventure travel in Europe, is not having their needs properly met.

Karen Kehoe plans to sell her shares in the clothing shop and invest the proceeds in a new business, Safari Europe. The business will operate from a self-contained facility within the existing shop, with its own entrance and shop window onto the main street.

The company believes that by concentrating on one market segment, the 25- to 35-year-old professionals, and one geographic destination, Europe, it will be able to deliver a significantly superior service to anything currently on the market.

Published research shows that tourism is a fast-growing business sector and Europe is the favoured location for most travellers. Adventure holidays, though a relatively new and small market, looks set for explosive growth.

Karen has selected a small team, some of whom have worked with her in the clothing shop for several years. She has worked as the manager of a branch of a high street travel agent and other members of the staff have extensive travel, selling, and computer skills, all of which will be invaluable to the new venture.

Safari Europe expects that by concentrating full time on selling adventure holidays, clients will increase from the present level of 200 in six months, achieved with only a part time effort, to at least 660 in the first year, 1,400 in the second, and 2,100 in the third. To help achieve this growth Karen has identified three other tour operators she wishes to represent and has begun negotiations with them. Selling between two and three holidays a day will allow the business to reach cash-flow break even in year one, while making a modest profit. This compares with the 1.3 holidays currently being sold each day.

By year 2 post-tax profits should be £180,000, and in year 3 nearly £300,000.

To achieve these results the company needs to invest in Web site and database software and systems, and in refurbishing the shop premises. Our market research demonstrates that sales of travel services via the Internet accounts for approaching £3 billion a year's worth of business. It is the fastest growing business to consumer activity on the Internet.

In all, about £75,000 will be needed to fund the business during its formative months. A further £10,000 needs to be available to deal with unforeseen events, although a sensitivity analysis has been carried out which shows this is unlikely to be required.

Karen will be investing £25,000 of her own money in the business, and seeking £60,000 from outside. The purpose of this business plan is to attract other shareholders to invest in a highly profitable venture. Return on shareholders' capital by year 3 will be close to 100 per cent. This opportunity may appeal to Karen's partners in the clothes shop or to a business angel.

Alternatively, we are considering loan finance made up of a £25,000 short-term loan and an overdraft facility of £35,000.

~ *The Business and Its Management* ~

Increasingly, shop customers have asked for advice on adventurous places to go on holiday. Last year Adventure Works took on an agency from European Adventure Holidays, one of the largest and most respected tour operators in this market, and began to promote and sell their products. In the six months that we have been selling travel agency products, some 200 holidays, at an average cost of £2,000, have been sold. Adventure Works' commission on the sales has been £40,000 (10 per cent commission). In addition, 35 insurance policies have been sold at an average price of £100, yielding £1,050 (30 per cent commission).

Mission

To be the leading provider of hassle-free European adventure holidays to the 25- to 35-year-old young professionals market. The business will initially operate within a 25-mile catchment area, but quickly start to sell its services worldwide, via the Internet. Sales of travel services is the fastest growing category of business to consumer activity on the Internet. In 2000 the value of this market will be an estimated £2.7 billion.

The emphasis will be on providing a complete specialist service based on having a detailed knowledge of the holiday destination and adventure activities being offered. Our market research shows that the major criticism our type of client has of existing travel agencies, is that they "know nothing about their products, they just open the catalogue and read", to quote one of the many disappointed adventure holidaymakers.

Also, by using our experience in the Adventure Works clothing shop, we will be able to both advise and direct our clients to sources of the type of travel equipment they will need to get the very best out of their holiday experience.

Objectives

Our financial objectives are to be operating at, or close to, cash flow break even by the end of the first year. We aim to be profitable from year 1 onwards, then we will aim to earn at least £180,000 post-tax profit in the second year, and nearly £300,000 in the third. Our profit margin on sales by year 3 will be a respectable 7 per cent.

We also intend that the business should be fun. The present staff are passionate about adventure holidays, and we intend to maintain their enthusiasm by constant product and skill training. We will only recruit new people who share our vision.

Legal Structure

The business will be set up as a limited company in the next few weeks. This structure will clearly separate the travel business from the shop and make it possible to attract the risk capital that will be required when the business starts to grow. For example, an Air Travel Operators License (ATOL) will eventually be required, which in turn calls for a business to have a minimum paid-up share capital of £25,000.

At a later stage the business may wish to sell and issue airline tickets and to create its own charter holidays. This will require membership of the International Air Traffic Association (IATA) and an Association of British Travel Agents (ABTA) bonding. However, in the period covered by this business plan we intend to operate only as the appointed agents for a number of tour operators. As such, we can shelter under their licenses and bonds.

~ Products and Services ~

▶ Tour Agency Products

We currently are appointed agents for European Adventure Holidays (EAH), a leading supplier in the market. Currently EAH offer some 40 different adventure holiday packages throughout Europe, covering such areas as: horse trekking in Iceland; above-the-clouds trekking on islands and remote mountain regions in such areas as Corsica and Norway; van-supported inn-to-inn bicycling; mountain biking and hiking adventure tours throughout France, Germany, Italy, and Austria; ballooning across the Alps.

We intend to seek to be appointed agents by three other major adventure holiday tour firms, with whom we are currently in negotiation.

▶ Services

We will offer a comprehensive range of complementary services to support the adventurous holidaymaker that will ensure they have a safe, enjoyable, and memorable experience. These services will include: insurance, both personal and effects; pre- and post-holiday briefing packs; a directory of advice and information services covering each country and adventure activity.

▶ Proprietary Position

Whilst at present we are offering only other company's adventure holidays we have protected our position in a number of ways.

Firstly, we have a two-year agency agreement with European Adventure Holidays which gives us access to all their holiday products, both existing and new. This contract is dependent on our achieving sales of at least 250 holiday packages a year. We intend to negotiate similar agreements with future suppliers, although sales targets with them will be lower to reflect their relative market position.

Secondly, we intend to maintain a high service element to our business, extending our range of value added services. In this way we will seek to build up a high level of repeat business. Customer loyalty is vital to our profitable growth.

▶ Guarantees and Customer Protection

Our clients will be protected financially against either our or our tour operators' failure, by virtue of the ABTA bonding held by our principals. We will only use holiday providers who can provide 24-hour emergency support services for clients whilst on holiday.

~ Markets and Competitors ~

▶ Markets, Projections, and Market Segments

The world travel market is forecast to expand at a 4.1 per cent average annual growth rate until 2012. This is faster than economic growth generally, which is expected to be around 2.4 per cent per annum.

The European market, whilst not the fastest growing, will be the most important destination, accounting for over 50 per cent of all international arrivals. France, Italy, and Spain are the most important destinations within Europe. This is why we have selected as our initial partners, tour operators with appropriate products in these countries.

Figures for the size and projected growth of adventure holidays are sketchy, but one recent study (World Adventure Travel Data Corp.) gave these figures.

Adventure Travel Holidays — World Forecast (Million Arrivals) : 2012 – 2015

Destination	2012	2013	2014	2015
Europe	0.25	0.60	1.60	2.35
N. America	0.45	0.60	1.40	2.20
Rest of World	0.10	0.25	0.95	1.10
Total	**0.85**	**1.45**	**3.95**	**5.65**

Age	2000 %	2020 %
16-24	61	38
25-35	20	31
36-45	15	25
46+	4	6
	100	**100**

Our own market study confirms that Europe is likely to be the largest destination market for adventure holidays. Our study shows only 30 per cent of adventure travellers to be under 24, whilst the World Adventure Travel Data study claims 61 per cent. We feel the difference is caused by our survey sample being confined to relatively affluent people who had spent at least £200 in adventure clothing.

One further emerging market-segment for adventure holidays is corporate clients. Our market research suggests that up to 20 per cent of adventure holidays are sold at this top-price end of the market.

Competition and Competitive Advantage

There are no adventure holiday specialist travel agents in the Bristol area. However, there are many in capital and secondary cities such as London, Paris, Lyon, Madrid, Barcelona, and Frankfurt. There are also a number of direct marketing and Internet providers. These are the types of competitors we expect to face:

General travel agents, who have added adventure holidays to their range. These agents often have little or no knowledge of adventure destinations or activities. They sell literally from the page, offering limited advice, information, and support. According to our market study 40 per cent of adventure holidays are booked through these general travel agents, but only 33 per cent of clients would use them again.

Adventure tour operators advertise their holidays in the press, attracting about 25 per cent of all adventure holiday clients. However, clients have to shop around several tour operators to find what they want, and they cannot get unbiased advice, or much help with information. Only 45 per cent would go back to a tour operator for their next holiday.

Independent travellers make up 15 per cent of those going on adventure holidays, and 65 per cent of those would travel that way again. We need to persuade this group that our superior product-knowledge and service is worth their consideration.

Internet providers sell only 5 per cent of adventure travel holidays. However, 70 per cent would buy their next holiday via the Internet. There is plenty of scope to offer a superior Web site. We believe that by having daily face-to-face contact with clients we will be better able to manage a fresh, vital, and relevant Web site aimed at the specific needs of our market segment.

Specialist adventure travel agencies only sell about 15 per cent of holidays at present, but we feel that this is due partly to lack of client awareness and partly to the comparative rarity of such outlets.

Some 65 per cent of those using specialist adventure holiday travel agents would use them again, which is many more than would use either a tour operator direct or a general travel agent.

However, these agents were criticized for having such a wide range of activities and destinations, that their sales agents knew little about them. Our research shows that whilst 41 per cent of clients take adventure holidays in Europe only 23 per cent of the 5,000 adventure tours on offer are for European destinations.

We feel that by concentrating on European destinations, which is the largest market for both holidays in general and adventure holidays in particular, we will be able to have superior product knowledge. We will only need to know perhaps 100 destinations and activities well, rather than have only a passing knowledge of the 5,000 adventure holidays on offer.

Our market research has also shown that many adventure travel agents are catering for the backpacker market, consisting mostly of very cost-conscious under 24-year-olds. This can lead to very different types of clients ending up at the same destination, with some consequent dissatisfaction. It is also evident that the backpacker market requires a much lower level of service and information, than do the more affluent professional 25- to 35-year-olds.

▶ *Customer Needs and Benefits*

We believe that by concentrating on the European market, offering a limited but extensive range of types of holiday, and aiming our service specifically at affluent professionals, we can meet the needs of our clients in a way not being achieved by any of our competitors.

Our market study has shown that this group has specific needs that are not currently being met, as 65 per cent of those taking adventure holidays would not buy from the same source again. In particular they want their travel agent to have comprehensive knowledge of the destination (87 per cent); to have an efficient administration system in which they can have confidence (84 per cent); to go on holiday with similar professional people (81 per cent); and to be offered useful advice and ancillary services such as insurance (79 per cent).

~ Competitive Business Strategy ~

▶ *Pricing Policy*

The normal commission paid to travel agents for this type of holiday is in the 10 to 15 per cent range. Whilst European Adventure Holidays, the first agency we have been appointed to, pay us at the lower end of the scale, they are a prestigious firm to represent. Having them in our portfolio will enable us to negotiate much higher commissions from our new principals. Accordingly we are planning on an average travel agency commission of 11 per cent rising to 13 per cent by the end of year 3. Commission on insurance and other services will be 30 per cent, throughout.

▶ *Promotional Plans*

Our market research shows that editorial has the greatest impact on people's choice of an adventure holiday, closely followed by having the right 'shop window', and having a recommendation from a friend, relation, or colleague. General press advertising seems to be fairly ineffective in this sector, and even specialist press advertising only draws in 14 per cent of clients.

Accordingly, our promotional plan is as follows:

Public Relations (PR). We will put considerable effort into preparing and disseminating a regular flow of press releases. These will be based on stories about our destinations, activities, corporate clients, and our staff. We will use a freelance PR adviser to help us write copy and target editors.

Shop Front. We plan to have an exciting, informative, and actively managed display window. There will be a video display showing holidays in progress. Different destinations can be selected from outside the window via a control panel, otherwise the scenes will rotate on a random basis.

Web Site. We will have a well-managed Web site. This is fast becoming a major promotional channel and we believe it will increase in importance over time. Also it is the easiest way for us to have a global presence at the outset.

Advertising. We will undertake a small amount of specialist-press advertising in order to enhance our PR activity. There is considerable research to support the argument that the more often a potential client hears about you, the more likely they are to approach you when they have a need for your type of service.

Database. Our database will retain full details of all our clients, the holidays they have taken, and their post-holiday appraisal data. We will use this data to provide incentives to our delighted clients prompting them to recommend our services to friends, relatives, colleagues, and employers.

Direct Mail. We will write to all past shop clients announcing the establishment of the travel business, and offering them a special introductory adventure holiday package.

▶ *Wider Factors Affecting Strategy*

The general economic climate in this city is good. A large influx of new businesses relocating from London and its surrounds, has added to the area's prosperity. There is now a large and growing young-professional population.

Tourism in general looks set to grow, Europe looks like continuing to be the major destination, and the Internet will be an important channel into this market.

Tourism is becoming a heavily regulated business sector. Whilst we have avoided most of the regulatory problems by becoming an appointed agent for a large established tour operator, in the future we will need our own ABTA bonding and ATOL registration.

~ Operations ~

Sales

Excellent selling skills are vital in our type of business, so everyone will be fully trained in selling. Every month we will audit each other by observing half a day's selling activity and giving feedback on strengths and weaknesses in skills.

Record Keeping

We will keep records of every sales contact. Data such as source of enquiry; client's needs; previous holidays; and job, income, and status, will be recorded. By having superior information on clients and prospects we intend to offer a truly personal service.

Premises

It is vital that the travel business has both a shop front facing onto the main street, and a visible separate entrance. It is intended that clothing-shop clients will be able to move between the premises without going outside. We will be renting 70 sq m (750 sq ft) of space at a cost of £18,000 per annum, fully serviced. In addition, we will need to spend £15,000 on internal refurbishments. We plan to do some of this work ourselves. Also a further £2,500 will be needed for office equipment such as desks and chairs.

Capacity

Our offices can accommodate five sales desks. Each sales desk has a capacity to handle 4 clients per hour, which means over the year we could handle up to 40,000 enquiries. With our average conversion rate of 1 in 5 we could service 9,600 clients from our present facilities. This is well above the numbers we are anticipating in the business plan.

Equipment

We will be renting an integrated telephone and database system from the outset. This will allow any of up to 10 sales staff to answer calls and have full on-screen data on clients and products. As service is one of our key differentiators, it is essential that all of us have full access to all relevant data speedily and efficiently.

▶ *Staffing*

From the outset, all staff will have job descriptions, a career and training history file, and a record of appraisals. New staff will take the travel agency psychometric aptitude test, and then spend time with each member of the Adventure Works Travel team.

All staff will undergo full product training, and will spend at least four weeks a year on site at key travel destinations. We plan to start with three full-time staff, including the founder, and one part timer. We plan to be operating with six staff during the third year of trading.

▶ *Quality Control*

We will be developing outline scripts to help sales staff manage enquiries. This will ensure that all incoming phone calls are dealt with in the same way and to a similar high standard.

We will encourage people enquiring about holidays to give us feedback on:

- Our ability to handle their enquiry.
- The way we manage between booking the holiday and taking the holiday.
- The client's reactions to the holiday, in terms of whether it meets their expectations.

~ Forecasts and Financial Data ~

▶ *Sales Forecast*

Our enquiry to sales conversion rate on the adventure travel holidays sold to date, whilst operating within the outdoor clothing shop, has been 33 per cent. For the purposes of our sales forecast, we are assuming that only 20 per cent of enquiries will actually result in an adventure holiday being booked. This is a very conservative estimate.

We expect there to be a steady build up of clients coming from the clothing shop to talk to us about holidays. However, the number of new enquiries generated by our promotional activity will also build up during the year, gradually overtaking enquiries from the clothes shop. This is a trend we expect to continue.

Based on the projection below, we are forecasting to sell 660 adventure travel holidays next year at an average price of £2,125.

Once insurance and other service sales are added in we expect to generate an income of £160,948 over the 12 months.

Sales Forecast Projection

	Q1	Q2	Q3	Q4	Year Total
Enquiries Generated Through Promotion	200	425	425	750	1,800
Adventure Shop Enquiries	300	300	450	450	1,500
Total Enquiries	**500**	**725**	**875**	**1,200**	**3,300**
Holidays Sold	100	145	175	240	660
Average Holiday's Cost	2,000	2,000	2,250	2,250	2,125
Commission Received	20,000	29,000	43,312	59,136	151,448
Commission on Insurance & Other Services Received	1,000	2,000	3,000	3,500	9,500
Total Commission & Fees Earned	**21,000**	**31,000**	**43,312**	**62,636**	**160,948**

In year 2 we are forecasting commission of £373,843, and in year 3 we plan to reach £590,926.

Cash Flow Projections and Sensitivity Analysis

The cash flow projections for year 1 show that after the owner has put in £25,000 the business will need additional short-term financing of about £50,000. For the last two months of the year we are forecasting a positive cumulative cash flow, and a year-end cash surplus of £11,937.

We have also done a sensitivity analysis to assess the impact on cash flow, if our sales of holidays were 10 per cent less than projected. We do not believe this to be a likely event. But even if it were to occur, our short-term financing needs would still not exceed £50,000 in any month. However, this scenario would leave the company with a small (£1,450) negative cash position at the year end.

In our cash flow projection we have assumed the whole £50,000 additional financing has come from a bank loan. We have allowed for interest on the full amount for the whole period. In practice, we would hope to finance part of this at least by an overdraft amount equal to the money actually required. In this way we believe we have made a prudent, conservative provision.

Profit and Loss Account

We expect to make a small after-tax profit in the first year of £21,898.This is before the owner's drawings. Any owner's drawings will be contingent on performance being better than that expected in the plan.

Projected Profits in Years 1 to 3

	Year 1	Year 2	Year 3
Turnover	1,416,071	3,115,356	4,545,588
Less Cost of Sales	1,255,123	2,741,513	3,954,662
Gross Profit	**160,948**	**373,843**	**590,926**
Less Expenses	133,575	145,750	207,000
Profit Before Tax	**27,373**	**228,093**	**383,926**
Provision for Tax	5,474	45,619	87,276
Proft After Tax	**21,898**	**182,474**	**296,650**

Balance Sheet

The balance sheet at the end of year 1 shows a healthy surplus of current assets over current liabilities. We have shown a conservative funding position, which does not include any of the additional capital that we hope to secure.

Performance Ratios

We plan to move our gross profit up from 11 per cent in year 1, to 13 per cent in year 3. These figures look quite low, but it should be remembered that our income is really the sales commission we earn, not the full price of an adventure holiday.

Our profit before tax is a more accurate measure of performance. This we expect to move from 2 per cent at the outset, up to 8 per cent by year 3.

Commission generated and profit per employee will be amongst the highest in the industry. At Brooker's Travel, for example, profit per employee never exceeded £19,500.

	Year 1	Year 2	Year 3
Gross Profit (%)	11	12	13
Profit Before Tax %	2	7	8
Commission Generated per Employee	£45,985	£83,076	£98,487
Profit per employee	£7,535	£41,471	£63,987

Break Even

To break even we will need to sell between 2 and 3 holidays a day. This compares with our present sales of 1.3 holidays a day, based on our part-time effort out of the clothing shop. So we feel confident that break even can be attained within a reasonable period.

~ Financing Requirements ~

Funds Required and Timing

The two major investments we plan to make are:

Web Site and Database Development (this will cost us £25,000). The database system is one of our key differentiators. It will allow us to offer superior service and ensure a high level of repeat business and referrals.

The Web site is vital if we are to reach this wide and disparate global market. The group of potential clients we have chosen as our target market (affluent, professional 25- to 35-year-olds) are prime users of the Internet. Even those people in our locality will expect to be able to research our offers on the Internet before coming to the shop.

Shop Premises Development (this will cost us £17,500). We have to look professional and to have an efficient work environment. If our staff do not have the right tools we can hardly expect them to deliver superior performance. If clients see an amateur premises, they will not be inspired to spend thousands of pounds and entrust their adventure holiday plans to us.

Both these investments need to be made at the outset to ensure the business creates the right impression from the start. We only get one chance to make a first impression.

We have decided to lease our telephone and computer systems as this is a rapidly changing area and we need to have access to the very latest technology. Financing packages from equipment suppliers are currently very attractive.

Funding Options

The owner plans to invest £25,000 of her own money (the proceeds of the sale of her share of the clothing shop business). The cash flow projections show that the business will require a further £50,000 of working capital during the early months of the first year's trading. We think we should provide for £60,000 to allow for unforeseen eventualities. We are considering two options for raising this.

Option 1: The sale of equity, perhaps to the original shop partners, of between £25,000 and £100,000. This would provide some capital to allow for growth. Any shortfall could be funded by overdraft or a bank loan.

Option 2: Approach our bank with a view to raising a medium-term loan of £25,000 and an overdraft facility of £35,000. Karen Kehoe could, with family help, provide any lender with security for part, if not all, of this facility.

~ Business Controls ~

Financial

We will be using a computer-based financial management system. This will allow us to analyse the profitability of sales of different holidays through each tour operator. In this way we can review our sales and marketing activities on a regular basis. It will also allow us to reward staff on the basis of profit achieved rather than just on sales.

Sales and Marketing

We will also be using a contact-management system that will allow us to monitor the effectiveness of different promotional strategies and of different marketing messages. The cornerstone of our strategic advantage lies in having superior data on prospects and clients.

Appendix: Market Research

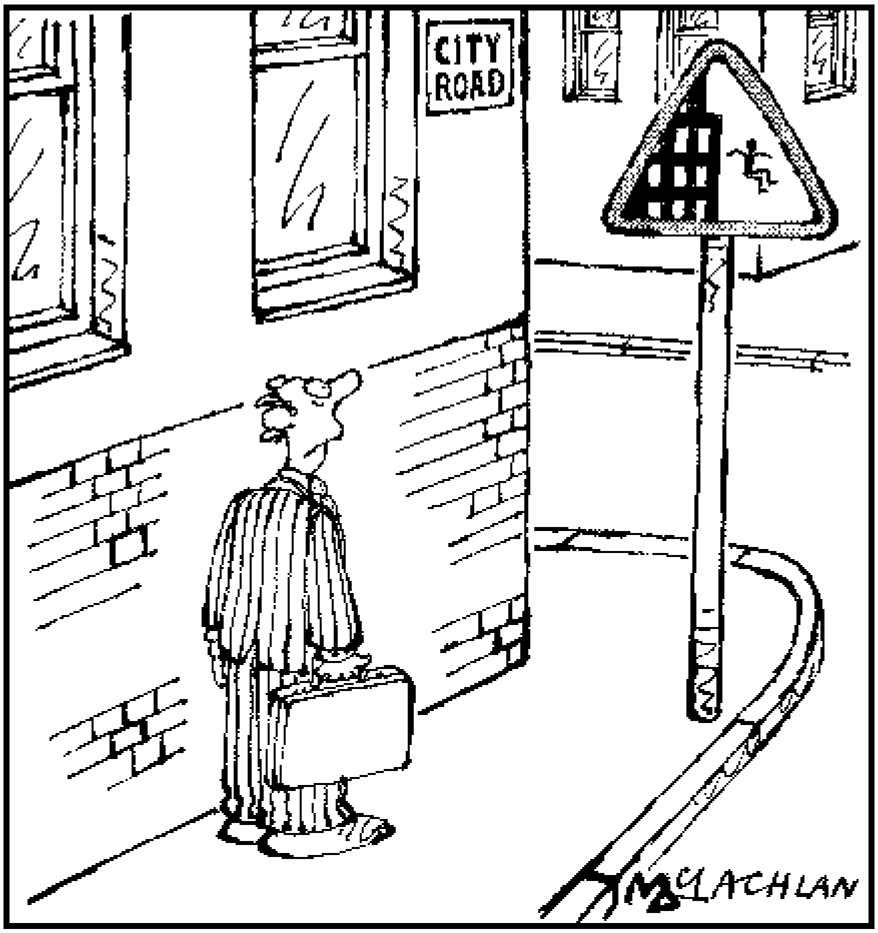
International Arrivals by World Region

Indicators of Tourism Demand

Summary of Findings From our Market Research

Adventure Works Travel Market Research Questionnaire

Part VI
The Part of Tens



In this part . . .

Every *For Dummies* book has one: Welcome to The Part of Tens. Here we list the ten most important questions to ask yourself about your business plan while you're working on it and we also point out the ten things you never ever want to be caught doing (while you're business planning, of course).

Chapter 18

Ten Questions to Ask About Your Plan

In This Chapter

- Looking over what you've done
- Making the necessary changes

It never hurts to step back every once in a while and take stock of where you stand. With that in mind, we've filled this chapter with all sorts of questions to mull over before you share your business plan with the world.

Are Your Goals Tied to Your Mission?

Look at the goals that you set for your business. These goals are the results that you absolutely, positively intend to achieve, and to a large extent, these goals determine how you set priorities and how you run your business. Your goals have to be consistent with one another so that you're not running in different directions at the same time. In addition, you have to tie your goals to your company's mission so that you're heading in the direction in which you really want to go.

Can You Point to Major Opportunities?

If you want your business to grow and prosper in the long haul, you have to take advantage of opportunities as they come along. Don't get too fixated on short-term economic problems, however severe; try to look over the horizon using your business plan to highlight the major opportunities that you see heading your way (in technology, markets and distribution, for example) and outline the actions that your company intends to take now so as to be in a position to take advantage of those opportunities down the road.

Have You Prepared for Threats?

You can easily paint a rosy picture of what the future holds for your company, but having a rosy picture doesn't necessarily mean that it's going to come true. Your company is in much better shape if you paint an objective picture – including the bad news along with the good. That way, you're prepared for the dangers that are bound to be there.

Your business plan should point out the biggest threats that loom on the horizon (a market slowdown, new regulations, or increasing competition, for example) and offer ways to prepare for them. If you recognise threats before anybody else does, you can often turn a threat into a real business opportunity. Use Chapter 15 to help spot economic turning points.

Have You Defined Your Customers?

The more you know about your customers – who they are, how they act, what they want – the more you know about your company. Customers tell you how to succeed in the marketplace.

Describing your customers is much easier if you think about dividing them into separate groups. Each group, or market segment, has its own unique profile and places its own set of demands on your company.

Your customers are so important to your company that you can't afford to leave them out of your business plan. You should answer three questions:

- Who is buying?
- What do they buy?
- Why do they buy?

Your plan should explain how your company intends to serve those customers better than anyone else out there.

Can You Track Your Competitors?

Your competitors are around to make life interesting. They're the companies that always try to woo your customers away, promising products or services that have better value (more benefits, lower prices), and you can't ignore them. You have to be able to identify who your competitors are, what they're doing and where they plan to go in the future.

Competition represents a big piece of your business environment. Your business plan should cover what you know about your competitors and – more important – how you intend to keep track of them on an ongoing basis. Your plan should also address how you intend to use what you find out to choose competitive battles that you can win.

Where Are You Strong (and Weak)?

You may find it hard to be objective in making an honest assessment of what your company does well and what it could do better. But your company's strengths and weaknesses determine its odds of success as you look ahead. Strengths and weaknesses refer to your company's capabilities and resources and how well they match up with the capabilities and resources that your company really needs to have in place to be successful. Check out Chapter 8 for more tips on carrying out a SWOT (Strenths, Weaknesses, Opportunities and Threats) analysis.

Your business plan should list your company's capabilities and resources – from management skills or research expertise to operations and distribution strength or loyal customers. But the plan must go on to describe how each of these capabilities or resources is a strength or a potential weakness, given your business situation and the industry in which you compete.

Does Your Strategy Make Sense?

Strategy has to do with how you intend to make your business plan happen. For starters, you have to pull together your company's strengths and weaknesses, the opportunities and threats that your company faces and the business goals that you set. Then, given all these pieces of the puzzle, you have to figure out a way to get where you want to be, in spite of all the things that stand in your way.

It should be clear, from beginning to end, that your business plan is based on an overall strategy that makes sense. Your company should have a strategy that's grounded in reality and that makes reasonable assumptions about what's happening and what's about to happen – a strategy that's logical and rational about what can be accomplished and how long it's going to take.

Can You Stand Behind the Numbers?

Think about all your financial statements as your company's report card – one that answers some big questions. Do your customers love you? Do your competitors respect you? Are you making the right business choices? A profit and loss account presents the bottom line, the balance sheet shows your business's financial health and the cash-flow statement keeps track of the money.

Your current financial statements tell everybody how well you're doing. But many people are more interested in your financial forecasts, which say what you expect to happen in the future. Just because these forecasts include official-looking numbers, however, doesn't mean that the predictions will necessarily come true. If you want to paint an honest picture of your company, your business plan should include a realistic financial portrait, based on assumptions that you believe in and numbers that you trust.

Are You Really Ready for Change?

If one thing remains constant in the business world, it's change. Although some industries change faster than others, everything around you – from technology to competition to your market – is going to be a little different tomorrow than it is today, no matter what business you're in. If you want to keep up, you have to think two or three steps ahead. You must look carefully and continually at what may happen in the world and how it may affect your company.

Although your business plan paints an honest picture of how you see your company and what you see happening down the road, the plan should also acknowledge the fact that you don't have a crystal ball. So present some options. Include one or two alternative business scenarios, asking – and answering – the question 'What if . . .?'

Is Your Plan Clear, Concise and Current?

Your plan should certainly capture all the things that you think are essential to know about your company and its situation – everything important that you discover in the process of planning your company. But none of the information that you present is going to be of any use to anyone else if your business plan is too long, impossible to read, or out of date.

Read over your own plan. Is it easy to understand? Is it easy to navigate? How long did it take you to read? Did you know where to find all the details? Did the details get in the way?

Chapter 19

Top Ten Business-Planning Never-Evers

In This Chapter

- Reviewing what to watch out for
- Fixing things that are broken

This chapter lists a few of those ‘I can’t believe I did that’ planning miscues that are all too easy to make. We list the top ten here so that you’ve a better chance of not making these mistakes yourself. But if you happen to make them anyway, at least you’ll know that you’re not alone.

Failing to Plan in the First Place

We’re probably preaching to the converted here, because you’re already reading this book. But neglecting to plan is a business sin so grave that it’s always worth a short sermon. Planning isn’t easy. After all, there are no right or wrong answers, and nothing’s guaranteed. But the planning process is bound to leave your company better prepared to face an uncertain future.

Although a business plan may not solve all your problems, it can help. Planning makes you a better manager and makes your business, no matter how large or small it is, more competitive and more likely to succeed in the long haul.

Missing Out on Assumptions

Your business plan has been prepared with your view of what the future holds. Those assumptions and the logic and evidence that underpin them should be documented. They can be referred to in the body of your business plan and then consigned to an appendix alongside other items of important data such as market research studies.

External assumptions

These are the factors that though completely out of your control, will have a direct bearing on the performance your business plan is claiming to be realistically attainable. The general economic environment of the countries you will be operating in should be top of your list of assumption. For example, at the time of writing the UK was expected to grow by between zero and 1 per cent, while growth in China and India was expected to be between 6 and 9 per cent, over the following two years. This would suggest very different trading conditions. The state of the economy will affect many business areas. A booming economy may be good for sales but it may make it harder to recruit new staff.

Internal assumptions

These include factors over which you've a measure of control, for example, when a new product or service should be ready, a website launched or updated, a supplier located, a licence applied for, or a quality standard achieved. The list of these factors is potentially long, so concentrate only on the important factors relevant to your business over the period of your business plan.

Second-Guessing the Customer

Everybody knows the cliché, 'The customer is always right.' Well, it's not a cliché for nothing. Whether you're trying to satisfy an individual customer face-to-face or attempting to figure out what an entire segment of the market needs and wants, you ignore what customers tell you at your own peril.

This idea seems so obvious that it's hardly worth repeating. But you may be surprised how many companies approach the marketplace with a 'We know just what you're looking for' attitude. Just remember that if you're not listening to your customers, one of your competitors is.

Underestimating Your Competition

Sometimes you can get so involved in working on your own product or service that you forget the other smart people out there who are trying to develop and market the same product or service. The more competitive your industry is, the smarter the competitors are and the more of them there seem to be.

Watching your competitors is just as important as listening to your customers. After all, if you want to stay ahead of the pack, you have to know what the rest of the pack is up to. The more you know about your competitors, the more you can use what you know to beat them at their own game.

Ignoring Your Own Strengths

Why does the grass always seem a little bit greener in the other company's garden? It usually isn't all that green when you get up close and look carefully, of course. But you may be tempted in business to think that other companies have all the right answers, the better way of doing things, the correct approach.

Oh, you can always discover things from your competition – no doubt about it. But what's right for one competitor isn't necessarily going to be the best way for you to do things. So don't forget to catalogue your company's own unique strengths and use them to your own advantage in the marketplace.

Mistaking a Budget for a Plan

Putting together your company's budget is one of the most critical steps in the business-planning process. A budget, after all, is where you make all the really big decisions about how much money to spend and where to spend it. Your budget plays a large role in determining what your company will do in the months and years ahead.

But don't ever mistake this budget for your business plan. The bulk of your plan is all the work that you do up front, before you begin to put your budget together in the first place. All that analysis of your industry, customers, competitors, and yourself makes your financial decisions the right ones – the ones that move your company closer to your larger business goals.

Shying Away from Reasonable Risk

Some people jump out of planes; others won't ride a big wheel. Some of us are willing to bet the house; others have trouble buying a lottery ticket. But no matter how you feel about risk, nothing's risk-free, especially in today's competitive markets.

Doing business means taking risks, and creating a business plan is one good way to manage those risks. Don’t shy away from making a bold business move – after you’ve done your homework, assessed the risk and know that the move is a reasonable step to take.

Allowing One Person to Dominate the Plan

Nobody has all the right answers (at least, no one we’ve met personally). So no matter how big or small your company is, don’t create a business plan all by yourself. Even if you’re the only one running the show, get other people you trust involved in your planning process – at the least, to review what you’ve done and provide an outside perspective. If your company’s bigger, involve as many people with different points of view as you can in your planning process. The more viewpoints you get, the stronger your business plan will be.

Being Afraid to Change

We all end up making changes in our lives. Sometimes we’re not given much choice in the matter, and most of us would prefer to go on doing the same things that we’ve always done, especially if we’re really good at them. Companies aren’t much different. You may find it hard to change the way that you do business or the kind of business that you do, and change is particularly hard if you’re really successful. But a good business plan alerts you to changes that your company should make before you’re forced to make them – changes that allow you to be more responsive to customers, more competitive, more efficient and more successful.

Forgetting to Motivate and Reward

A business plan isn't useful if it never gets out of your head or off the page. Your business blueprint has to be translated into the efforts and activities of all the people in your company – and it has to make sense to every one of them.

You have to link your strategy to your vision; link your vision to the company mission; link your mission to the goals and objectives that you set. Then you have to link all these pieces of the plan to the way in which you motivate and reward the people around you.

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- Find your way around the balance sheet and profit and loss account
- Choose the right accounting method
- Budget with confidence

John A. Tracy
Former staff accountant for Ernst & Young

Colin Barrow
Venture capitalist and author of
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John A Tracy is Professor of Accounting, Emeritus, in the College of Business and Administration at the University of Colorado in Boulder. Before his 35-year tenure at Boulder he was on the business faculty for four years at the University of California in Berkeley. He has served as staff accountant at Ernst & Young and is the author of several books on accounting, including The Fast Forward MBA in Finance and How To Read a Financial Report. Dr Tracy received his MBA and PhD degrees from the University of Wisconsin and is a CPA in Colorado.

Colin Barrow was until recently Head of the Enterprise Group at Cranfield School of Management, where he taught entrepreneurship on the MBA and other programmes and where he is still a visiting fellow. He is also a visiting professor at business schools in the US, Asia, France and Austria. His books on entrepreneurship and business have been translated into over twenty languages including Russian and Chinese. He worked with Microsoft to incorporate the business planning model used in his teaching programmes into the software program, Microsoft Business Planner, bundled with Office. He is a regular contributor to newspapers, periodicals and academic journals such as The Financial Times, The Guardian, Management Today and the International Small Business Journal.

Thousands of students have passed through Colin's start-up and business growth programmes, raising millions in new capital and going on to run successful and thriving enterprises. Some have made it to *The Sunday Times* Rich List. He has been a non-executive director of two venture capital funds, on the board of several small businesses, and serves on a number of

Government Task Forces. Currently he is a non-executive director in several private firms and works with family businesses in the Middle East on succession planning.

Dedication

For all my grandchildren.

John A Tracy

Authors' Acknowledgments

From John: I'm deeply grateful to everyone at Wiley who helped produce this book. Their professionalism and their unfailing sense of humour and courtesy were much appreciated. I owe a debt of gratitude to a faculty colleague at Boulder, an accomplished author in his own right, Professor Ed Gac. He offered very sage advice. Ed was always ready with a word of encouragement when I needed one, and I'm very appreciative.

I often think about why I like to write books. I believe it goes back to an accounting class in my undergraduate days at Creighton University in Omaha. In a course taught by the Dean of the Business School, Dr Floyd Walsh, I turned in a term paper and he said that it was very well written. I have never forgotten that compliment. I think he would be proud of this book.

From Colin: I would like to thank everyone at Wiley for the opportunity to write this book, as well as their help, encouragement, feedback and tireless work to make this all happen.

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Understanding Business Accounting For Dummies®

Visit www.dummies.com/cheatsheet/understandingbusinessaccountinguk to view this book's cheat sheet.

Table of Contents

Introduction

Welcome to *Understanding Business Accounting For Dummies*, 3rd Edition. We've written this book for people who need to understand accounting information and financial reports, quickly. Unsurprisingly the business climate at the end of the first decade of the 21st Century has made this a hot topic – not quite in the Stieg Larsson league but every bit as scary in its own way. While it's *not* for accountants and bookkeepers, they should find this book very interesting and a good refresher course. This book is for people who need to use and understand accounting information – business managers and entrepreneurs, for example, who need to raise money, make profit, turn profit into cash flow and control the assets and liabilities of their venture. If you're running a business or you're a business unit manager, we're probably preaching to the converted when we say that you need a basic familiarity with accounting and financial statements in order to make good business decisions.

Business investors, lawyers, business consultants – pretty much anyone who reads (or aspires to read) *The Financial Times* – can also benefit from a solid understanding of how to read financial reports and how accounting works.

About This Book

Understanding Business Accounting For Dummies, 3rd Edition lifts the veil of obscure terminology and lays bare the methods of accounting. This book takes you behind the scenes and explains the language and methods of accounting in a down-to-earth and light-hearted manner – and *in plain English*.

Each chapter in this book is designed to stand on its own. Each chapter is self-contained, and you can jump from chapter to chapter as you please (although we encourage you to take a quick tour through the chapters in the order that we present them). We bet you'll discover some points that you may not have expected to find in a book about accounting.

Conventions Used in Financial Reports

Much of this book focuses on profit and how a business makes profit. Because profit and other financial aspects of a business are reported in *financial statements*, understanding some basic notations and conventions used in these financial reports is important.

We use the following condensed profit and loss account to illustrate some conventions that you can expect to see when reading financial reports. (The actual format of a profit and loss account includes more information about expenses and profit.) These conventions are the common ways of showing figures in financial reports just as saying hello and shaking hands are common conventions that you can expect when you greet someone.

Abbreviated Profit and Loss Account

Sales revenue		£25,000,000
Cost of goods sold expense	15,000,000	
Gross margin	£10,000,000	
Marketing expenses	£4,000,000	
Other expenses	2,000,000	6,000,000
Profit		£4,000,000

- You read a financial statement from the top down. In this sample profit and loss account, for example, sales revenue is listed first followed by cost of goods sold expense because this particular expense is the first expense deducted from sales revenue. The other two expenses are listed below the first profit line, which is called gross margin.
- The sample profit and loss account includes two columns of numbers. Note that the 6,000,000 total of the two expenses in the left column is entered in the right column. Some financial statements display all figures in a single column.
- An amount that is deducted from another amount – like cost of goods sold expense in this sample profit and loss account – may have parentheses around the amount to indicate that it is being subtracted from the amount just above it. Or, financial statements may make the assumption that you know that expenses are deducted from sales revenue – so no parentheses are put around the number. You see expenses presented both ways in financial reports. But you hardly ever see a minus or negative sign in front of expenses – it's just not done.
- Notice the use of pound signs in the sample profit and loss account. Not all numbers have a pound sign in front of the number. Financial reporting practices vary on this matter. We prefer to use pound signs only for the first number in a column and for a calculated number. In some financial reports, pound signs are put in front of all numbers, but usually they aren't.
- To indicate that a calculation is being done, a single underline is drawn under the bottom number, as you see below the 15,000,000 cost of goods sold expense number in the sample profit and loss account.

- The final number in a column is usually double underlined, as you can see for the £4,000,000 profit number in the sample profit and loss account. This is about as carried away as accountants get in their work – a double underline. Again, actual financial reporting practices are not completely uniform on this point – instead of a double underline on a bottom-line number, the number may appear in **bold.**
- Sometimes statements note that the amounts shown are in thousands (this prevents clogging up neat little columns with loads of noughts). So if a statement noting 'amounts in thousands' shows £300, it actually means £300,000. And that can make quite a difference!

When we present an accounting formula that shows how financial numbers are computed, we show the formula indented, like this:

Assets = Liabilities + Owners' Equity

Terminology in financial reporting is reasonably uniform, thank goodness, although you may see a fair amount of jargon. When we introduce a new term in this book, we show the term in *italics* and flag it with an icon (see the section 'Icons Used in This Book' later in this Introduction). You can also turn to Appendix A to look up a term that you're unfamiliar with.

Foolish Assumptions

While this book is designed for all of you who have that nagging feeling that you really should know more about accounting, we have made a few assumptions about you.

You don’t want to be an accountant, nor do you have any aspirations of ever sitting for the FCA (Fellow of the Institute of Chartered Accountants) exam. But you worry that ignorance of accounting may hamper your decision-making, and you know deep down that learning more about accounting would help.

We assume that you have a basic familiarity with the business world, but we take nothing for granted in this book regarding how much accounting you know. Even if you have some experience with accounting and financial statements, we think you’ll find this book useful – especially for improving your communication with accountants.

We assume that you need to *use* accounting information. Many different types of people (business managers, investors and solicitors, to name but three) need to understand accounting basics – not all the technical stuff, just the fundamentals.

We assume that you want to know something about accounting because it’s an excellent gateway for understanding how business works, and it gives you an indispensable vocabulary for moving up in the business and investment worlds. Finding out more about accounting helps you understand earnings reports, mergers and takeovers, frauds and pyramid schemes, and business restructurings.

TIP

Let us point out one other very practical assumption that we have regarding why you should know some accounting. We call it the *defensive* reason. A lot of people out there in the cold, cruel financial world may take advantage of you, not necessarily by illegal means, but by withholding key information and by diverting your attention away from unfavourable aspects of certain financial decisions. These unscrupulous characters treat you as a lamb waiting to be fleeced. The best defence against such tactics is to learn some accounting basics, which can help you ask the right questions and understand the financial points that tricksters don't want you to know.

How This Book Is Organised

This book is divided into parts, and each part is further divided into chapters. The following sections describe what you can find in each part.

Part I: Accounting Basics

Part I of *Understanding Business Accounting For Dummies*, 3rd Edition introduces accounting to non-accountants and discusses the basic features of bookkeeping and accounting record-keeping systems. This part also talks about taxes of all kinds that are involved in running a business, as well as accounting in the everyday lives of individuals.

Part II: Getting a Grip on Financial Statements

Part II moves on to the end product of the business accounting process – *financial statements.* Three main financial statements are prepared every period – one for each financial imperative of business: making *profit*, keeping *financial condition* in good shape and controlling *cash flow.* The nature of profit and the financial effects of profit are explained in Chapter 5. The assets, liabilities and owners' capital invested in a business are reported in the *balance sheet*, which is discussed in Chapter 6. Cash flow from profit and the *cash flow statement* are explained carefully in Chapter 7. The last chapter in this part, Chapter 8, explains what managers have to do to get financial statements ready for the annual financial report of the business to its owners.

Part III: Accounting in Managing a Business

Business managers should know their financial statements like the backs of their hands. However, just understanding these reports is not the end of accounting for managers. Chapter 9 kicks off this part with an extraordinarily important topic – building a basic profit model – that clearly focuses on the key variables that drive profit. This model is absolutely critical for decision-making analysis.

Chapter 10 discusses accounting-based planning and control techniques, especially budgeting. Business managers and owners have to decide on the best business ownership structure, which we discuss in Chapter 11. Managers in manufacturing businesses should be wary of how product costs are determined – as Chapter 12 explains. This chapter also explains other economic and accounting costs that business managers use in making decisions. Chapter 13 identifies and explains the alternative accounting methods for expenses and how the choice of method has a major impact on profit for the period, and on the cost of stock and fixed assets reported in the balance sheet.

Part IV: Financial Reports in the Outside World

Part IV explains financial statement reporting for investors. Chapter 14 presents a speed-reading approach that concentrates on the key financial ratios to look for in a financial report. The scope of the annual audit and what to look for in the auditor's report are explained in Chapter 15, which also explains the role of auditors as enforcers of financial accounting and disclosure standards.

Part V: The Part of Tens

This part of the book presents four chapters. Chapter 16 presents some practical ideas for managers to help them put their accounting knowledge to use while Chapter 17 lists various sources of finance available to the business. Chapter 18 gives business investors some handy tips on things to look for in a financial report – tips that can make the difference between making a good investment and a not-so-good one. Chapter 19 provides our take on reading the stars. Sure, no one knows everything about the financial future, but here we outline some ways you can spot a cloud before it becomes a thunder storm.

Part VI: Appendixes

At the back of the book, you can find two helpful appendixes that can assist you on your accounting safari. Appendix A provides you with a handy, succinct glossary of accounting terms. Appendix B fills you in on the accounting software programs available for your business.

Icons Used in This Book

For Dummies books always include little icons in the margins to draw your attention to paragraphs of particular significance:

This icon calls your attention to particularly important points and offers useful advice on practical financial topics. This icon saves you the cost of buying a yellow highlighter pen.

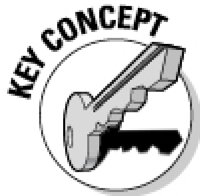
This icon serves as a friendly reminder that the topic at hand is important enough for you to put a note about it in the front of your wallet. This icon marks material that your lecturer might put on the board before the class starts, noting the important points that you should remember at the end of the class.

Accounting is the language of business, and, like all languages, the vocabulary of accounting contains many specialised terms. This icon identifies key accounting terms and their definitions. You can also check the glossary (Appendix A) to find definitions of unfamiliar terms.

This icon is a caution sign that warns you about speed bumps and potholes on the accounting highway. Taking special note of this material can steer you around a financial road hazard and keep you from blowing a fiscal tyre. In short – watch out!

We use this icon sparingly; it refers to very specialised accounting stuff that is heavy going, which only an FCA could get really excited about. However, you may find these topics important enough to return to when you have the time. Feel free to skip over these points the first time through and stay with the main discussion.

This icon alerts you that we're using a practical example to illustrate and clarify an important accounting point. You can apply the example to your business or to a business in which you invest.



This icon points out especially important ideas and accounting concepts that are particularly deserving of your attention. The material marked by this icon describes concepts that are the building blocks of accounting – concepts that you should be very clear about, and that clarify your understanding of accounting principles in general.

Where to Go from Here

If you're new to the accounting game, by all means, start with Part I. However, if you already have a good background in business and know something about bookkeeping and financial statements, you may want to jump right into Part II of this book, starting with Chapter 5. Part III is on accounting tools and techniques for managers and assumes that you have a handle on the financial statements material in Part II. Part IV stands on its own; if your main interest in accounting is to make sense of and interpret financial statements, you can read through Part II on financial statements and then jump to Part IV on reading financial reports. If you have questions about specific accounting terms, you can go directly to the glossary in Appendix A.

We've had a lot of fun writing this book. We sincerely hope that it helps you become a better business manager and investor, and that it aids you in your personal financial affairs. We also hope that you enjoy the book. We've tried to make accounting as fun as possible, even though it's a fairly serious subject. Just remember that accountants never die; they just lose their balance. (Hey, accountants have a sense of humour, too.)

Part I
Accounting Basics

'So for all you eager investors, our latest financial report will be read to you by our new accountant, Mr Mesmero.'

In this part . . .

Accounting is important in all walks of life, and it's absolutely essential in the world of business, never more so than when the economy goes pear shaped. Accountants are the bookkeepers, scorekeepers, and occasionally the gatekeepers of business. Without accounting, a business couldn't function, wouldn't know whether it's making a profit or loss, wouldn't know its financial situation, or if it was in danger of running out of cash.

Bookkeeping – the record-keeping part of accounting – must be managed well to make sure that all the financial information needed to run the business is complete, accurate, and reliable, especially the numbers reported in financial statements and tax returns. Wrong numbers in financial reports and tax returns can cause all sorts of trouble.

Speaking of taxes, you can't take more than three or four steps before bumping into dreaded taxes. No one likes to pay taxes, but managers must collect and pay taxes as part of running a business. In addition to income taxes, accounting plays a bigger role in your personal financial affairs than you might realise. This part of the book explains all this and more.

Chapter 1

Introducing Accounting to Non-Accountants

In This Chapter

- Understanding the different needs for accounting
- Making and enforcing accounting rules
- Peering into the back office: The accounting department in action
- Transactions: The heartbeat of a business
- Taking a closer look at financial statements
- Should you let your baby grow up to be an accountant?

Most medium to large businesses employ one or more accountants. Even a very small business could find value in having at least a part-time accountant. Have you ever wondered why? Probably what you think of first is that accountants keep the books and the records of the financial activities of the business. This is true, of course. But accountants perform other very critical but less well-known functions in a business:

- Accountants carry out vital back-office operating functions that keep the business running smoothly and effectively including payroll, cash receipts and cash payments, purchases and stock, and property records.
- Accountants prepare tax returns, including VAT (value-added tax) returns for the business, as well as payroll and investment tax returns.

- Accountants determine how to measure and record the costs of products and how to allocate shared costs among different departments and other organisational units of the business.
- Accountants are the *professional profit scorekeepers* of the business world, meaning that they are the ones who determine exactly how much profit was earned, or just how much loss the business suffered, during the period. Accountants prepare reports for business managers, keeping them informed about costs and expenses, how sales are going, whether the cash balance is adequate and what the stock situation is. Most importantly, accountants help managers understand the reasons for changes in the bottom-line performance of a business.
- Accountants prepare *financial statements* that help the owners and shareholders of a business understand where the business stands financially. Shareholders wouldn't invest in a business without a clear understanding of the financial health of the business, which regular financial reports (sometimes just called *the financials*) provide.

In short, accountants are much more than bookkeepers – they provide the numbers that are so critical in helping business managers make the informed decisions that keep a business on course toward its financial objectives.

Business managers, investors and others who depend on financial statements should be willing to meet accountants halfway. People who use accounting information, like spectators at a football game, should know the basic rules of play and how the score is kept. The purpose of this book is to make you a knowledgeable spectator of the accounting game.

Accounting Everywhere You Look

Accounting extends into virtually every walk of life. You're doing accounting when you make entries in your cheque book and fill out your income tax return. When you sign a mortgage on your home you should understand the accounting method the lender uses to calculate the interest amount charged on your loan each period. Individual investors need to understand some accounting in order to figure the return on capital invested. And every organisation, profit-motivated or not, needs to know how it stands financially. Accounting supplies all that information.

Many different kinds of accounting are done by many different kinds of persons or entities for many different purposes:

- Accounting for organisations and accounting for individuals.
- Accounting for profit-motivated businesses and accounting for non-profit organisations (such as hospitals, housing associations, churches, schools and colleges).
- Income tax accounting while you're living and estate tax accounting after you die.
- Accounting for farmers who grow their products, accounting for miners who extract their products from the earth, accounting for producers who manufacture products and accounting for retailers who sell products that others make.
- Accounting for businesses and professional firms that sell services rather than products, such as the entertainment, transportation and health care industries.

- Past-historical-based accounting and future-forecast-oriented accounting (that is, budgeting and financial planning).
- Accounting where periodic financial statements are mandatory (businesses are the primary example) and accounting where such formal accounting reports are not required.
- Accounting that adheres to cost (most businesses) and accounting that records changes in market value (investment funds, for example).
- Accounting in the private sector of the economy and accounting in the public (government) sector.
- Accounting for going-concern businesses that will be around for some time and accounting for businesses in bankruptcy that may not be around tomorrow.

Accounting is necessary in any free-market, capitalist economic system. It's equally necessary in a centrally controlled, socialist economic system. All economic activity requires information. The more developed the economic system, the more the system depends on information. Much of the information comes from the accounting systems used by the businesses, individuals and other institutions in the economic system.

The Basic Elements of Accounting

Accounting involves bookkeeping, which refers to the painstaking and detailed recording of economic activity and business transactions. But *accounting* is a much broader term than *bookkeeping* because accounting refers to the design of the bookkeeping system. It addresses the many problems in measuring the financial effects of economic activity. Furthermore, accounting includes the *financial reporting* of these values and performance measures to non-accountants in a clear and concise manner. Business managers and investors, as well as many other people, depend on financial reports for vital information they need to make good economic decisions.

Accountants design the *internal controls* in an accounting system, which serve to minimise errors in recording the large number of activities that a business engages in over the period. The internal controls that accountants design can detect and deter theft, embezzlement, fraud and dishonest behaviour of all kinds. In accounting, internal controls are the gram of prevention that is worth a kilo of cure.

An accountant rarely prepares a complete listing of all the details of the activities that took place during a period. Instead, he or she prepares a *summary financial statement,* which shows totals, not a complete listing of all the individual activities making up the total. Managers may occasionally need to search through a detailed list of all the specific transactions that make up the total, but this is not common. Most managers just want summary financial statements for the period – if they want to drill down into the details making up a total amount for the period, they ask the accountant for this more detailed backup information. Also, outside investors usually only see summary-level financial statements. For example, they see the total amount of sales revenue for the period but not how much was sold to each and every customer.

Financial statements are prepared at the end of each accounting period. A period may be one month, one quarter (three calendar months), or one year. One basic type of accounting report prepared at the end of the period is a 'Where do we stand at the end of the period?' type of report. This is called the *balance sheet.* The date of preparation is given in the header, or title, above this financial statement. A balance sheet shows two aspects of the business.

One aspect is the *assets*, or economic resources, of the business. The other aspect of the balance sheet is a breakdown of where the assets came from, or the sources of the assets. The asset *values* reported in the balance sheet are the amounts recorded when the assets were originally acquired. For many assets these values are recent – only a few weeks or a few months old. For some assets, the values as reported in the balance sheet are the costs of the assets when they were acquired many years ago.

Assets are not like manna from heaven. They come from borrowing money in the form of loans that have to be paid back at a later date and from owners' investment of capital (usually money) in the business. Also, making profit increases the assets of the business; profit retained in the business is the third basic source of assets. If a business has, say, £2.5 million in total assets (without knowing which particular assets the business holds) you know that the total of its liabilities, plus the capital invested by its owners, plus its retained profit, adds up to £2.5 million.

In this particular example suppose that the total amount of the liabilities of the business is £1.0 million. This means that the total amount of *owners' equity* in the business is £1.5 million, which equals total assets less total liabilities. Without more information we don't know how much of total owners' equity is traceable to capital invested by the owners in the business and how much is the result of profit retained in the business. But we do know that the total of these two sources of owners' equity is £1.5 million.

The financial condition of the business in this example is summarised in the following *accounting equation* (in millions):

£2.5 Assets = £1.0 Liabilities + £1.5 Owners' Equity

Looking at the accounting equation you can see why the statement of financial condition is also called the balance sheet; the equal sign means the two sides have to balance.

Double-entry bookkeeping is based on this accounting equation – the total of assets on the one side is counter-balanced by the total of liabilities, invested capital and retained profit on the other side. Double-entry bookkeeping is discussed in Chapter 2.

Other financial statements are different from the balance sheet in one important respect: They summarise the significant *flows* of activities and operations over the period. Accountants prepare two types of summary flow reports for businesses:

- The **profit and loss account** summarises the inflows of assets from the sale of products and services during the period. The profit and loss account also summarises the outflow of assets for expenses during the period leading down to the well-known *bottom line* (the final profit or loss) for the period.

- The **cash flow statement** summarises the business's cash inflows and outflows during the period. The first part of this financial statement calculates the net increase or decrease in cash during the period from the profit-making activities reported in the profit and loss account.

The balance sheet, profit and loss account, and cash flow statement constitute the hard core of a financial report to those persons outside a business who need to stay informed about the business's financial affairs. These individuals have invested capital in the business, or the business owes them money and therefore they have a financial interest in how well the business is doing. These three key financial statements are also used by the managers of a business to keep themselves informed about what's going on and the financial position of the business. They are absolutely essential to helping managers control the performance of a business, identify problems as they come up, and plan the future course of a business. Managers also need other information that is not reported in the three basic financial statements. (Part III of this book explains these additional reports.)

The jargon jungle of accounting

Financial statements include many terms that are reasonably clear and straightforward, like *cash, debtors* and *creditors.* However, financial statements also use words like *retained earnings, accumulated depreciation, accelerated depreciation, accrued expenses, reserve, allowance, accrual basis* and *current assets.* This type of jargon in accounting is perhaps too common: It's everywhere you look. If you have any doubt about a term as you go along in the book, please take a quick look in Appendix A, which defines many accounting terms in plain English.

Accounting and Financial Reporting Standards

Experience and common sense have taught business and financial professionals that uniform financial reporting standards and methods are critical in a free-enterprise, private, capital-based economic system. A common vocabulary, uniform accounting methods and full disclosure in financial reports are the goals. How well the accounting profession performs in achieving these goals is an open question, but few disagree that they are worthy goals to strive for.

The emergence of international financial reporting standards (IFRS)

The accounting professional bodies, with a little prodding from governments, are responsible for ensuring that accounting reports conform to what are known as Generally Accepted Accounting Practices (GAAP). A newish entrant, International Accounting Standards, is challenging that term itself as GAAP rules have been interpreted differently on different continents and indeed largely ignored on others. The whole subject of accounting standards is still being thrashed out. In October 2010 the Accounting Standards Board issued a Financial Reporting Exposure Draft (FRED) proposing a new financial reporting standard to replace current UK and Republic of Ireland financial reporting standards.

The rule book has to be adapted to accommodate changes in the way business is done. For example, international business across frontiers is now the norm, so rules on handling currency and reporting taxable profits in different countries have to be accommodated within a company's accounts in a consistent manner.

Although you aren't usually expected to know all the rules – unless you're the accountant responsible for preparing your organisation's figures, try to get up-to-date before any meetings where the subject is likely to come up. You can keep track of changes in company reporting rules on the Institute of Chartered Accountants website (`www.icaew.com/en/technical/financial-reporting`).

In the UK there's a large degree of conformity between domestic and international standards, and the Accounting Standards Board considers each new international standard carefully before deciding whether or not to include it in the domestic standard. Topics that have been the cause of disagreement in the recent past are the treatment of goodwill, deferred tax and pension costs.

JARGON ALERT

> The role of the Accounting Standards Board (ASB) is to issue accounting standards. It took over the task of setting accounting standards from the Accounting Standards Committee (ASC) in 1990. The ASB also collaborates with accounting standard-setters from other countries and the International Accounting Standards Board (IASB) both in order to influence the development of international standards and in order to ensure that its standards are developed with due regard to international

developments. You can keep up with its work at www.frc.org.uk/asb/.

Why accounting rules are important

Business managers should know the basic features of the accounting rules applying in their area – though certainly not all the technical details – so that they understand how profit is measured. Managers get paid to make profit, and they should be very clear on how profit is measured and what profit consists of. The amount of profit a business makes depends on how *profit* is defined and measured.

For example, a business records the purchase of products at cost, which is the amount it paid for the products. *Stock* is the name given to products being held for sale to customers. Examples include clothes in a department store, fuel in the tanks in a petrol station, food on the shelves in a supermarket, books in a bookstore, and so on. The cost of products is put in the stock asset account and kept there until the products are sold to customers. When the products are eventually sold, the cost of the products is recorded as the cost of goods sold expense, at which time a decrease is recorded in the stock asset account. The cost of products sold is deducted from the sales revenue received from the customers, which gives a first-step measure of profit. (A business has many other expenses that need to be factored in, which you can read about in later chapters.)

Now, assume that before the business sells the products to its customers the replacement cost of many of the products being held in stock awaiting sale increases. The replacement cost value of the products is now higher than the original, actual purchase cost of the products. The company's stock is worth more, is it not? Perhaps the business could raise the sales prices that it charges its customers because of the cost increase, or perhaps not. In any case, should the increase in the replacement cost of the products be recorded as profit? The manager may think that this holding gain should be recorded as profit. But the accepted accounting standards say that no profit is earned until the products are sold to the customers.

What about the opposite movement in replacement costs of products – when replacement costs fall below the original purchase costs? Should this development be recorded as a loss, or should the business wait until the products are sold? As you'll see, the accounting rule that applies here is called *lower of cost or market*, and the loss is recorded. So the rule requires one method on the upside but another method on the downside. See why business managers and investors need to know something about the rules of the game? We should add that accounting rules are not all crystal-clear, which leaves a lot of wriggle room in the interpretation and application of these accounting standards. But first a quick word about accounting rules and income tax accounting.

Income tax and accounting rules

Generally speaking (and we're being very general when we say the following), HM Revenue & Customs' income tax accounting rules for determining the annual taxable income of a business are in agreement with the accounting rules applied in most other developed economies. In other words, the accounting methods used for figuring taxable income and for figuring business profit before income tax are in general agreement. Having said this, we should point out that several differences do exist. A business may use one accounting method for filing its annual income tax returns and a different method for measuring its profit, both for management reporting purposes and for preparing its external financial statements to outsiders.

Flexibility in accounting standards

An often-repeated accounting story concerns three accountants being interviewed for an important position. The accountants are asked one key question: 'What's 2 plus 2?' The first candidate answers, 'It's 4,' and is told, 'Don't call us, we'll call you.' The second candidate answers, 'Well, most of the time the answer is 4, but sometimes it's 3 and sometimes it's 5.' The third candidate answers: 'What do you want the answer to be?' Guess who got the job?

The point is that accounting rules are not entirely airtight or cut-and-dried, and are being updated. Many accounting standards leave a lot of room for interpretation. *Guidelines* would be a better word to describe some accounting rules. Deciding how to account for certain transactions and situations requires flexibility, seasoned judgement and careful interpretation of the rules. Furthermore, many estimates have to be made.

Sometimes, businesses use what's called *creative accounting* to make profit for the period look better. Like lawyers who know where to find legal loopholes, accountants sometimes come up with inventive solutions but still stay within the guidelines. We warn you about these creative accounting techniques – also called *massaging the numbers* – at various points in this book. Articles in financial newspapers and magazines regularly focus on such accounting abuses.

Enforcing Accounting Rules

As we mentioned in the preceding sections, when preparing financial statements a business must follow generally accepted accounting principles – the authoritative ground rules for measuring profit and for reporting values of assets and liabilities. Everyone reading a financial report is entitled to assume that the country's accepted accounting standards have been followed (unless the business clearly discloses that it is using another so-called comprehensive basis of accounting).

The basic idea behind sticking closely to the accepted accounting standards is to measure profit and to value assets and liabilities *consistently* from business to business – to establish broad-scale uniformity in accounting methods for all businesses. The idea is to make sure that all accountants are singing the same tune from the same hymnbook. The purpose is also to establish realistic and objective methods for measuring profit and putting values on assets and liabilities. The authoritative bodies write the tunes that accountants have to sing.

All systems of accounting standards include minimum requirements for *disclosure*, which refers to how information is classified and presented in financial statements and to the types of information that have to be added to the financial statements in the form of footnotes. Chapter 8 explains these disclosures that are required in addition to the three primary financial statements of a business (the profit and loss account, balance sheet and cash flow statement).

The Accounting Standards Board, the body responsible for setting accounting standards in the UK, is undertaking a programme of gradually ripping up UK GAAP and replacing it with international financial reporting standards. Today, companies with outside shareholders in the UK and across Europe have bitten the bullet and are adopting international accounting standards, known as International Financial Reporting Standards (IFRS). International standards sound like a great idea – especially with the introduction of a single European currency and the emergence of pan-European equity markets. In fact most financial directors of public companies want to be able to adopt IFRS ahead of time. The UK's Accounting Standards Board is pressing ahead with a programme to 'converge' UK accounting standards so that they match the international standards – almost. You can keep track of changes in company reporting rules on the Institute of Chartered Accountants' website at www.icaew.com/en/technical/financial-reporting. How do you know if a business has actually followed the rules faithfully? We think it boils down to two factors. First is the competency and ethics of the accountants who prepared the financial reports. No substitute exists for expertise and integrity. But accountants often come under intense pressure to massage the numbers from the higher-level executives that they work for.

Which leads to the second factor that allows you to know if a business has obeyed the dictates of accounting standards. Businesses have their financial statements audited by independent chartered or management accountants. In fact, limited companies are required by law to have annual audits and many private businesses hire accountants to do an annual audit, even if not legally required. The Companies Act 2006 has introduced some tough rules on how auditors, amongst others, should report on company accounts. Chapter 15 explains audits and why investors should carefully read the auditor's report on the financial statements.

Protecting investors: Sarbanes-Oxley and beyond

A series of high profile financial frauds in US-based businesses such as Enron and WorldCom in the mid to late 1990s badly shook people's confidence in US businesses. In response, the US government introduced the Sarbanes-Oxley Act, known less commonly but better understood as ‘the Public Company Accounting Reforms and Investor Protection Act – 2002’.

The central tenet of the Sarbanes-Oxley Act is to ensure truthfulness in financial reporting – a quest the accounting profession has been pursuing since Pacioli set out the rules of double-entry bookkeeping five centuries ago. The act closes the loopholes that creative accountants opened up, which made it difficult (and sometimes impossible) for shareholders to see how a business was performing until after the baddies had made off with the loot. The act applies to any business with shares listed on an American stock market that does business in the US – not just to US companies.

The British version, ‘the Companies (Audit, Investigations, and Community Enterprise) Act – 2004’, is causing the accounting profession to clutch its collective head. This knock-on effect from Sarbanes-Oxley means that all companies selling shares to the public have to make changes to their accounts and accounting standards. You can read up on the UK rules at www.legislation.gov.uk/ukpga/2004/27/contents.

The Accounting Department: What Goes On in the Back Office

As we discussed earlier in this chapter, bookkeeping (also called *record-keeping*) and financial reporting to managers and investors are the core functions of accounting. In this section, we explain another basic function of a business’s accounting department: the back-office functions that keep the business running smoothly.

Most people don't realise the importance of the accounting department. That's probably because accountants do many of the back-office, operating functions in a business – as opposed to sales, for example, which is front-line activity, out in the open, and in the line of fire.

Typically, the accounting department is responsible for:

- **Payroll:** The total wages and salaries earned by every employee every pay period, which are called *gross wages* or *gross earnings,* have to be determined. In short, payroll is a complex and critical function that the accounting department performs; the correct amounts of income tax, social security tax and other deductions from gross wages have to be calculated.
- **Cash inflows:** All cash received from sales and from all other sources has to be carefully identified and recorded, not only in the cash account but also in the appropriate account for the source of the cash received. In larger organisations, the *Chief Accountant* may be responsible for some of these cash flow and cash-handling functions.
- **Cash payments:** A business writes many cheques during the course of a year to pay for a wide variety of items including local business taxes, paying off loans and the distribution of some of its profit to the owners of the business. The accounting department prepares all these cheques for the signatures of the officers of the business who are authorised to sign cheques, and keeps the relevant supporting documents and files for the company's records.
- **Purchases and stock:** Accounting departments are usually responsible for keeping track of all purchase orders that have been placed for stock (products to be

sold by the business) and all other assets and services that the business buys – from postage stamps to forklift trucks. The accounting department also keeps detailed records on all products held for sale by the business and, when the products are sold, records the cost of the goods sold.

- **Capital accounting:** A typical business holds many different assets called *capital* – including office furniture and equipment, retail display cabinets, computers, machinery and tools, vehicles, buildings and land. The accounting department keeps detailed records of these items.

The accounting department may be assigned other functions as well, but we think that this list gives you a pretty clear idea of the back-office functions that the accounting department performs. Quite literally, a business could not operate if the accounting department did not do these functions efficiently and on time.

Focusing on Business Transactions and Other Financial Events

Understanding that a great deal of accounting focuses on business transactions is very important. *Transactions* are economic exchanges between a business and the persons and other businesses with which the business deals. Transactions are the lifeblood of every business, the heartbeat of activity that keeps the business going. Understanding accounting, to a large extent, means understanding the basic accounting methods and practices used to record the financial effects of transactions.

A business carries on economic exchanges with six basic groups:

- Its **customers,** who buy the products and services that the business sells.
- Its **employees,** who provide services to the business and are paid wages and salaries and provided with a broad range of benefits such as a pension plan and paid holidays.
- Its **suppliers** and **vendors,** who sell a wide range of things to the business, such as legal advice, electricity and gas, telephone service, computers, vehicles, tools and equipment, furniture, and even audits.
- Its **debt sources of capital,** who loan money to the business, charge interest on the amount loaned, and have to be repaid at definite dates in the future.
- Its **equity sources of capital,** the individuals and financial institutions that invest money in the business and expect the business to earn profit on the capital they invest.
- The **government agencies** that collect income taxes, payroll taxes, value-added tax and excise duties from the business.

Figure 1-1 illustrates the interactions between the business and the other parties in the economic exchange.

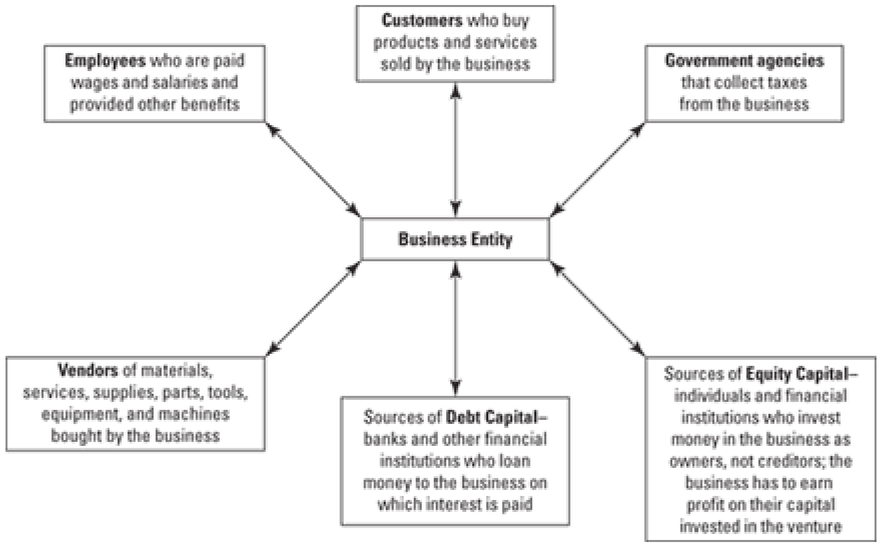


Figure 1-1: The six-spokes of transactions between a business and the parties with which it engages in economic exchanges.

Even a relatively small business generates a surprisingly large number of transactions, and all transactions have to be recorded. Certain other events that have a financial impact on the business have to be recorded as well. These are called *events* because they're not based on give-and-take bargaining – unlike the something-given-for-something-received nature of economic exchanges. Events such as the following have an economic impact on a business and have to be recorded:

- A business may lose a lawsuit and be ordered to pay damages. The liability to pay the damages should be recorded.
- A business may suffer a flood loss that is uninsured. The water-logged assets may have to be written off, meaning that the recorded values of the assets are reduced to nil if they no longer have any value to the business.
- A business may decide to abandon a major product line and downsize its workforce, requiring that severance be paid to laid-off employees.

Taking a Closer Look at Financial Statements

As we mention in the preceding sections, accountants prepare certain basic financial statements for a business. The three basic financial statements are the following:

- **Balance Sheet:** A summary of the financial position of the business at the end of the period.
- **Profit and loss account:** A summary of sales revenue and expenses that determines the profit (or loss) for the period just ended. This is also called the *income statement,* or simply abbreviated to the *P&L statement.* (Alternative titles also include the *operating statement* and the *earnings statement*.)
- **Cash flow statement:** A summary of cash inflows and cash outflows for the period just ended.

This section gives you a description of these statements that constitute a business's financial centre of gravity. We show you the general format and content of these three accounting reports. The managing director and chief executive officer of a business (plus other top-level managers and financial officers) are responsible for seeing that the financial statements are prepared according to financial reporting standards and that proper accounting methods have been used to prepare the financial statements.

If a business's financial statements are later discovered to be seriously in error or misleading, the business and its top executives can be sued for damages suffered by lenders and investors who relied on the financial statements. For this reason, business managers should understand their responsibility for the financial statements and the accounting methods used to prepare the statements. In a court of law, they can't plead ignorance.

We frequently meet managers who don't seem to have a clue about the three primary statements. This situation is a little scary; a manager who doesn't understand financial statements is like an aeroplane pilot who doesn't understand the instrument readouts in the cockpit. A manager *could* run the business and 'land the plane safely', but knowing how to read the vital signs along the way is much more prudent.

In short, business managers at all levels – from the board of directors down to the lower rungs on the management ladder, and especially managers of smaller businesses who have to be jacks-of-all-trades in running the business – need to understand financial statements and the accounting methods used to prepare the statements. Also, lenders to a business, investors in a business, business lawyers, government regulators of business, entrepreneurs, employees who depend on the continued financial success of the business for their jobs, anyone thinking of becoming an entrepreneur and starting a business, and, yes, even economists, should know the basics of financial statement accounting. We've noticed that even experienced business journalists, who ought to know better, sometimes refer to the balance sheet when they're talking about profit performance. The bottom line is found in the profit and loss account, not the balance sheet!

The balance sheet

JARGON ALERT

The balance sheet is the essential financial statement that reports the main types of assets owned by a business. Assets are only half the picture, however. Almost all businesses borrow money. At the date of preparing the balance sheet, a business owes money to its lenders, who will be paid sometime in the future. Also, most businesses buy many things on credit and at the balance sheet date owe money to their suppliers, which will be paid in the future. Amounts owed to lenders and suppliers are called *liabilities.* A balance sheet reports the main types of liabilities of the business, and separates those due in the short term and those due in the longer term.

Could total liabilities be greater than a business's total assets? Well, not likely – unless the business has been losing money hand-over-fist. In the vast majority of cases a business has more total assets than total liabilities. Why? For two reasons: (1) its owners have invested money in the business, which is not a liability of the business; and (2) the business has earned profit over the years and some of the profit has been retained in the business. (Profit increases assets.) The sum of invested capital from owners and retained profit is called *owners' equity*. The excess of total assets over total liabilities is traceable to owners’ equity. A balance sheet reports the make-up of the owners’ equity of a business.

You generally see the balance sheet in the following layout:

Basic Format of the Balance Sheet

Assets, or the economic resources the business owns: examples are cash on deposit, prod ucts held for sale to customers, and buildings.	**Liabilities,** which arise from borrowing money and buying things on credit. **Owners’ Equity,** which arises from two sources: money invested by the owners, and profit earned and retained by the business.

One reason the balance sheet is called by this name is that the two sides balance, or are equal in total amounts:

Total Recorded Amount of Assets = Total Recorded Amount of Liabilities + Total Recorded Amount of Owners’ Equity

Owners’ equity is sometimes referred to as *net worth.* You compute net worth as follows:

Assets – Liabilities = Net Worth

Net worth is not a particularly good term because it implies that the business is worth the amount recorded in its owners’ equity accounts. Though the term may suggest that the business could be sold for this amount, nothing is further from the truth. (Chapter 6 presents more information about the recorded value of owners' equity reported in the balance sheet, and Chapter 14 discusses the market prices of shares, which are units of ownership in a business corporation.)

The profit and loss account

The profit and loss account is the all-important financial statement that summarises the profit-making activities (or operations) of a business over a time period. In very broad outline, the statement is reported like this:

Basic Format of the Profit and Loss Account

Sales Revenue (from the sales of products and services to customers)

Less Expenses (which include a wide variety of costs paid by the business, including the cost of products sold to customers, wages and benefits paid to employees, occupancy costs, administrative costs and income tax)

Equals Net Income (which is referred to as the *bottom line* and means final profit after all expenses are deducted from sales revenue)

The profit and loss account gets the most attention from business managers and investors – not that they ignore the other two financial statements. The very abbreviated versions of profit and loss accounts that you see in the financial press, such as in *The Financial Times,* report only the top line (sales revenue) and the bottom line (net profit). In actual practice, the profit and loss account is more involved than the basic format shown here. Refer to Chapter 5 for more information on profit and loss accounts.

The cash flow statement

The cash flow statement presents a summary of the sources and uses of cash in a business during a financial period. Smart business managers hardly get the word *profit* out of their mouths before mentioning *cash flow.* Successful business managers can tell you that they have to manage both profit *and* cash flow; you can't do one and ignore the other. Business is a two-headed dragon in this respect. Ignoring cash flow can pull the rug out from under a successful profit formula. Still, some managers become preoccupied with making profit and overlook cash flow.

For financial reporting, cash flows are divided into three basic categories:

Basic Format of the Cash Flow Statement

(1) **Cash flow** from the profit-making activities, or *operating activities,* for the period (***Note:*** *Operating* means the profit-making transactions of the business.)

(2) **Cash inflows and outflows** from *investing activities* for the period

(3) **Cash inflows and outflows** from the *financing activities* for the period

You determine the bottom-line net increase (or decrease) in cash during the period by adding the three types of cash flows shown in the preceding list.

Part 1 explains why net cash flow from sales revenue and expenses – the business's profit-making operating activities – is more or less than the amount of profit reported in the profit and loss account. The *actual* cash inflows from revenues and outflows for expenses run on a different timetable than the sales revenue and expenses, which are recorded for determining profit. It's like two different trains going to the same destination – the second train (the cash flow train) runs on a later schedule than the first train (the recording of sales revenue and expenses in the accounts of the business). Chapter 7 explains the cash flow analysis of profit as well as the other sources of cash and the uses of cash.

Part 2 of the cash flow statement sums up the major long-term investments made by the business during the year, such as constructing a new production plant or replacing machinery and equipment. If the business sold any of its long-term assets, it reports the cash inflows from these divestments in this section of the cash flow statement.

Part 3 sums up the financing activities of the business during the period – borrowing new money from lenders and raising new capital investment in the business from its owners. Cash outflows to pay off debt are reported in this section, as well as cash distributions from profit paid to the owners of the business.

The cash flow statement reports the net increase or net decrease in cash during the year (or other time period), caused by the three types of cash flows. This increase or decrease in cash during the year is never referred to as the *bottom line.* This important term is strictly limited to the last line of the profit and loss account, which reflects net income – the final profit after all expenses are deducted.

Imagine you have a highlighter pen in your hand, and the three basic financial statements of a business are in front of you. What are the most important numbers to mark? Financial statements do *not* have any numbers highlighted; they don't come with headlines like newspapers. You have to find your own headlines. *Bottom-line profit* in the profit and loss account is one number you would mark for sure. Another key number is *cash flow from operating activities* in the cash flow statement, or some variation of this number. Cash flow has become very important these days. Chapter 7 explains why this internal source of cash is so important and the various definitions of *cash flow* (did you think there was only one meaning of this term?).

Accounting as a Career

In our highly developed economy, many people make their living as accountants – and here we're using the term *accountant* in the broadest possible sense. Despite the introduction of new technology, the number of people employed in accountancy as a profession has shown extensive growth in the past three decades. Accountants work in many areas of business and the public sector in roles ranging from sole practitioner to chief executive of a multinational company. In public practice firms, from small high street to large international practices, accountants provide professional services to a wide range of fee-paying clients from the private individual to large commercial and public sector organisations. These services include audit/assurance, accountancy, tax, business advisory and other management services. In commerce/industry and the public sector, chartered accountants work in a variety of financial management and financial reporting roles. It is possible for accountants to set up their own firm or become a partner in a private practice. This requires a Practising Certificate, which is awarded by one of the relevant qualifying bodies to accountants with at least two years' experience. There are also opportunities to work abroad.

Because accountants work with numbers and details, you hear references to accountants as bean counters, digit heads, number nerds and other names we don't care to mention here. Accountants take these snide references in their stride and with good humour. Actually, accountants come out among the most respected professionals in many surveys.

Chartered accountant (CA)

In the accounting profession, the mark of distinction is to be a *CA*, which stands for *chartered accountant.* The majority of chartered accountants train in public practice and the first three years are devoted to achieving the chartered qualification. The training involves completion of professional exams together with a period of structured work experience. The professional exam training is provided by the Institute of Chartered Accountants in England and Wales (ICAEW) (www.icaew.co.uk), which is the largest, the Institute of Chartered Accountants of Scotland (ICAS) (www.icas.org.uk), and the Chartered Accountants Ireland (ICAI) (www.icai.ie) – Dublin Office. The structure of the exams and methods of training delivery vary slightly between the institutes and full details can be found on their websites. However, the qualifications cover broadly similar syllabuses and are of equal status and recognition, all leading to the designation ‘chartered accountant’ (ACA or CA). The syllabuses cover subjects such as accounting, audit, business finance, taxation, law and business management, which are assessed primarily through formal exams. Chartered accountants must remain up-to-date on technical and business issues, so there is a strong emphasis on continuing professional development after qualification.

Other professional bodies that train accountants and are useful to know about include the Chartered Institute of Management Accountants (www.cimaglobal.com), who focus on accounting for and in business, the Chartered Institute of Public Finance and Accountancy (www.cipfa.org.uk), who specialise in the public sector, and the Association of Accounting Technicians (www.aat.org.uk), whose 36,000 members assist chartered accountants in their work, or can themselves join a chartered institute after further study.

The financial controller: The chief accountant in an organisation

After working for an accountancy firm in public practice for a few years, most CAs leave public accounting and go to work for a business or other organisation. Usually, they start at a mid-level accounting position with fairly heavy accounting responsibilities, but some step in as the top accountant in charge of all accounting matters of a business. The top-level accountant in a business organisation is usually called the *financial controller*, or *chief accountant*.

The financial controller designs the entire accounting system of the business and keeps it up-to-date with changes in the tax laws and changes in the accounting rules that govern reporting financial statements to outside lenders and owners. Controllers are responsible for hiring, training, evaluating, promoting and sometimes firing the persons who hold the various bookkeeping and accounting positions in an organisation – which range from payroll functions to the several different types of tax returns that have to be filed on time with different government agencies.

The controller is the lead person in the financial planning and budgeting process of the business organisation. Furthermore, the financial controller designs the accounting reports that all the various managers in the organisation receive – from the sales and marketing managers to the purchasing and procurement managers. These internal reports should be designed to fit the authority and responsibility of each manager; they should provide information for managers' decision-making analysis needs and the information they need to exercise effective control.

The controller also designs and monitors the accounting reports that go to the business's top-level executives, the chief executive officer of the business, and the board of directors. All tough accounting questions and problems get referred to the controller. The controller needs good people management skills, should know how to communicate with all the non-accounting managers in the organisation and at the same time should be an 'accountant's accountant' who has deep expertise in many areas of accounting.

Smaller businesses may have only one or two 'accountants'. The full-time bookkeeper or office manager may carry out many of the duties that would belong to the financial controller in a larger organisation. Smaller businesses often call in a chartered accountant in public practice to advise their accountants. The chartered accountant may function more or less as a part-time controller for a small business, preparing the annual income tax returns and helping to prepare the business's external financial reports.

Accounting branches: Treasury, tax and audit

Accounting from a career perspective can be broken down into three main branches, with some overlap between, particularly in smaller enterprises where, in effect, all three areas are the responsibility of a single person or department:

- **Financial accounting** is concerned with preparing financial statements summarising past events, usually in the form of profit and loss accounts and balance sheets. These historic statements are mainly of interest to outside parties such as investors, loan providers and suppliers.
- **Management accounting** involves assembling much more detailed information about current and future planned events to allow management to carry out their roles of planning, control and decision-making. Examples of management accounting information are product costs and cost data relevant to a particular decision, say, a choice between make or buy. Also included in management accounting are preparing and monitoring budgeted costs relating to a product, activity or service. Management accounting information is rarely disclosed to outside parties, though bankers and private equity providers often ask for monthly management accounts as a condition of funding.
- **Financial management** covers all matters concerning raising finance and ensuring it is used in the most efficient way. For example it would be financially inefficient to raise a long-term loan or sell shares just to finance a short-term increase in sales. It would be the role of financial management to select and use a more cost-effective funding source such as an overdraft. The cost of capital is influenced by both the capital structure adopted as well as the risk of the investments undertaken.

Within these three broad areas of accounting there may be further subsets of accounting relating either to one specific activity, or across the whole spectrum. For example:

- **Treasury** is a finance function usually only found in a very large company or group of companies. For example, the managing of bank balances to get the maximum interest on positive balances or to minimise the payment of interest on negative balances would be a typical treasury task. This might involve lending money overnight on the money markets. Treasury activity would also be concerned with the managing of exchange risk where financial transactions in foreign currencies are involved.
- **Taxation** in a small company is included in the duties of the financial accountant who may need to call on outside professional advice from time to time. Corporation tax on company profits isn't straightforward and the system of capital allowances can be complex for some large companies, groups of companies or multinational companies. The ramifications of value added tax (VAT), sales tax where it applies, employee tax and other related deductions such as National Health Insurance and director benefits in kind, often call for the services of a specialist accountant, or team of accountants. Large companies usually use the services of such firms to minimise the pain and maximise the gain from such taxes and allowances.
- **Audit** is another accounting function mainly found in larger organisations. Internal auditors monitor that accounting procedures, documents and computerised transactions are carried out correctly. This work is additional or complementary to that undertaken by external auditors who take a broader approach in

providing an independent report to shareholders in the annual report. See Chapter 15 where we discuss this subject in greater depth.

Chapter 2

Bookkeeping 101: From Shoe Boxes to Computers

In This Chapter

- Understanding the difference between bookkeeping and accounting
- Following the steps in the bookkeeping cycle
- Managing the bookkeeping and accounting system
- Getting down the basics of double-entry accounting
- Deterring and detecting errors, irregularities and outright fraud

Most people are pretty terrible bookkeepers just because they really don't do much bookkeeping. Admit it. Maybe you balance your chequebook against your bank statement every month and somehow manage to pull together all the records you need for your annual income tax return. But you probably stuff your bills in a drawer and just drag them out once a month when you're ready to pay them. (Hey, that's what we do.) And you almost certainly don't prepare a detailed listing of all your assets and liabilities (even though a listing of assets is a good idea for insurance purposes). We don't prepare a summary statement of our earnings and income for the year or a breakdown of what we spent our money on and how much we saved. Why not? Because we don't need to! Individuals can get along quite well without much bookkeeping – but the exact opposite is true for a business.

One key difference between individuals and businesses is that a business must prepare periodic *financial statements*, the accuracy of which is critical to the business's survival. The business uses the accounts and records generated by its bookkeeping process to prepare these statements; if the accounting records are incomplete or inaccurate, the financial statements will be incomplete or inaccurate. And inaccuracy simply won't do.

Obviously, then, business managers have to be sure that the company's bookkeeping and accounting system is adequate and reliable. This chapter shows managers what bookkeepers and accountants do – mainly so that you can make sure that the information coming out of your accounting system is complete, timely and accurate.

Bookkeeping versus Accounting

Bookkeeping is essentially the process (some would say the drudgery) of recording all the information regarding the transactions and financial activities of a business – the record-keeping aspects of accounting. Bookkeeping is an indispensable subset of accounting. The term *accounting* goes much further, into the realm of designing the bookkeeping system in the first place, establishing controls to make sure that the system is working well, and analysing and verifying the recorded information. Bookkeepers follow orders; accountants give orders.

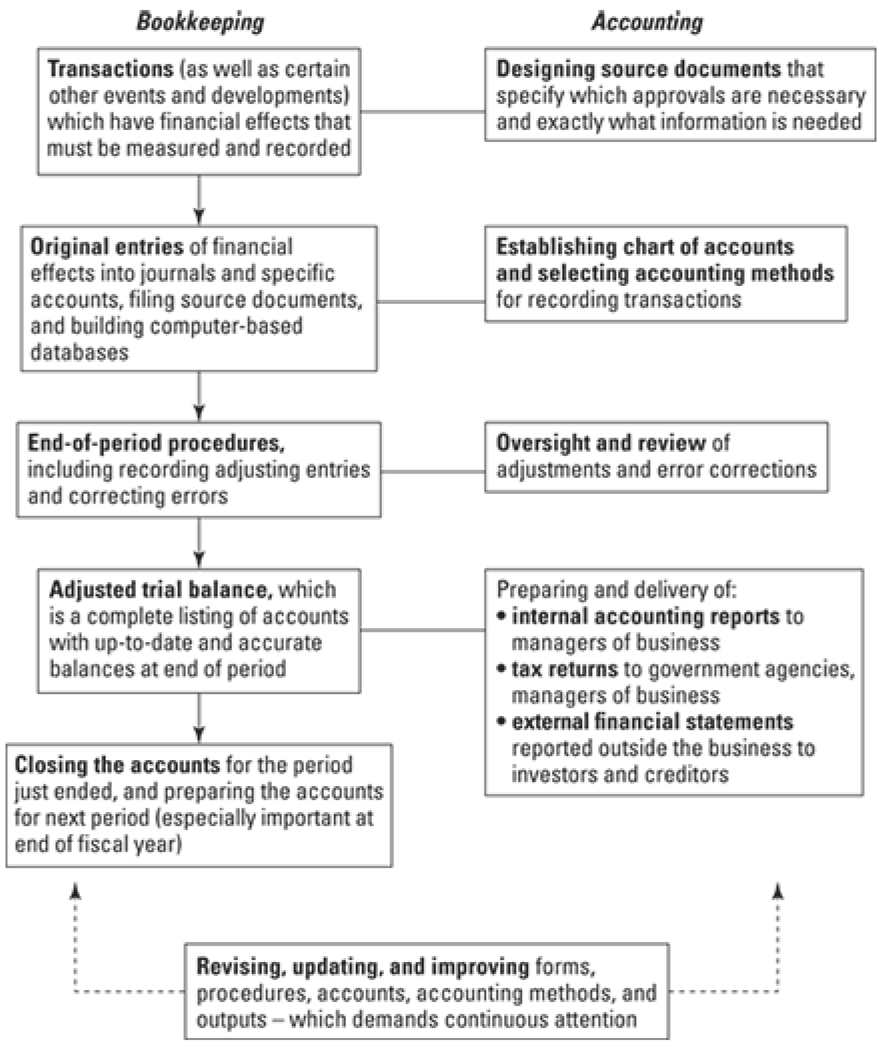
Accounting can be thought of as what goes on before and after bookkeeping. Accountants prepare reports based on the information accumulated by the bookkeeping process – financial statements, tax returns and various confidential reports to managers. Measuring profit is a very important task that accountants perform, a task that depends on the accuracy of the information recorded by the bookkeeper. The accountant decides how to measure sales revenue and expenses to determine the profit or loss for the period. The tough questions about profit – where it is and what it consists of – can't be answered through bookkeeping alone.

The rest of this book doesn't discuss bookkeeping in any detail – no talk of debits and credits and all that stuff. All you really need to know about bookkeeping, as a business manager, is contained in this chapter alone.

Pedalling through the Bookkeeping Cycle

Figure 2-1 presents an overview of the bookkeeping cycle side-by-side with elements of the accounting system. You can follow the basic bookkeeping steps down the left-hand side. The accounting elements are shown in the right-hand column. The basic steps in the bookkeeping sequence, explained briefly, are as follows. (See also 'Managing the Bookkeeping and Accounting System,' later in this chapter, for more details on some of these steps.)

Figure 2-1: The basic steps and sequence of the bookkeeping cycle, including the accounting inputs and outputs.



1. Record *transactions* – the economic exchanges between a business and the other people and businesses that it deals with.

Transactions have financial effects that must be recorded – the business is better off, worse off or at least 'different off' as the result of its transactions. Examples of typical business transactions include paying employees, making sales to customers, borrowing money from the bank and buying products that will be sold to customers. The bookkeeping process begins by identifying all transactions and capturing the relevant information about each transaction.

2. Prepare and collect *source documents* – transaction documentation that the bookkeeper uses to record the

transactions.

When buying products, a business gets a *purchase invoice* from the supplier. When borrowing money from the bank, a business signs for an *overdraft*, a copy of which the business keeps. When a customer uses a credit card to buy the business's product, the business gets the *credit card slip* as evidence of the transaction. When preparing payroll cheques, a business depends on *salary schedules* and *time cards.* All of these key business forms serve as sources of information into the bookkeeping system – in other words, information the bookkeeper uses in recording the financial effects of the transaction.

3. Record original entries (the financial effects of the transactions) into journals and accounts.

Using the source document(s) for every transaction, the bookkeeper makes the first, or original, entry into a journal and then into the business's accounts. Only an official, established book of accounts should be used in recording transactions. A *journal* is a chronological record of transactions in the order in which they occur – like a very detailed personal diary. In contrast, an *account* is a separate record for each asset, each liability and so on. One transaction affects two or more accounts. The journal entry records the whole transaction in one place; then each piece is recorded in the two or more accounts changed by the transaction.

Here's a simple example that illustrates recording of a transaction in a *journal* and then *posting* the changes caused by the transaction in the *accounts.* Expecting a big demand from its customers, a retail bookshop purchases, on credit, 50 copies of *Understanding Business Accounting For Dummies* from the publisher, John Wiley & Sons, Ltd. The books are received and placed on the shelves. (50 copies are a lot to put on the shelves, but our relatives promised to rush down and buy several copies each.) The bookshop now owns the books and also owes John Wiley £600.00, which is the cost of the 50 copies. You look only at recording the purchase of the books, not recording subsequent sales of the books and paying the bill to John Wiley.

The bookshop has established a specific stock or account called 'Stock-Trade Paperbacks' for books like this. And the purchase liability to the publisher should be entered in the account 'Creditor-Publishers'. So the journal entry for this purchase is recorded as follows:

Stock-Trade Paperbacks + £600.00 Creditor-Publishers + £600.00

This pair of changes is first recorded in one journal entry. Then, sometime later, each change is *posted,* or recorded, in the separate accounts – one an asset and the other a liability.

Not so long ago, bookkeepers had to record these entries by hand, and even today there's nothing wrong with a good hand-entry (manual) bookkeeping system. But bookkeepers can now use computer programs that take over many of the tedious chores of bookkeeping. Computers have come to the rescue – of course, typing has replaced hand cramps with repetitive strain injury, but at least the work gets done more quickly and with fewer errors! (See Appendix B for more about popular accounting software packages for personal computers.)

We can't exaggerate the importance of entering transaction data correctly and in a timely manner. For example, an important reason that most retailers these days use cash registers that read bar-coded information on products is to more accurately capture the necessary information and to speed up the entry of this information.

4. Perform end-of-period procedures – preliminary steps for preparing the accounting reports and financial statements at the end of every period.

A *period* can be any stretch of time – from one day to one month to one quarter (three months) to one year and is determined by the needs of the business. A year is usually the longest period of time that a business would wait to prepare its financial statements. As a matter of fact, most businesses need accounting reports and financial statements at the end of each quarter, and many need monthly financial statements.

Before the accounting reports can be prepared at the end of the period (see Figure 2-1), the bookkeeper needs to bring the accounts of the business up-to-date and complete the bookkeeping process. One step, for example, is recording the *depreciation expense* for the period (see Chapter 6 for more on depreciation). Another step is getting an actual count of the business's stock so that the stock records can be adjusted to account for shoplifting, employee theft and so on.

The accountant needs to take the final step and check for errors in the business's accounts. Data entry clerks and bookkeepers may not fully understand the unusual nature of some business transactions and may have entered transactions incorrectly. One reason for establishing *internal controls* (discussed in 'Protect the family jewels: Internal controls', later in this chapter) is to keep errors to an absolute minimum. Ideally, accounts should contain very few errors at the end of the period, but the accountant can't make any assumptions and should make a final check for any errors that fell through the cracks.

5. **Prepare the adjusted trial balance for the accountants.**

   After all the end-of-period procedures have been completed, the bookkeeper prepares a complete listing of all accounts, which is called the *adjusted trial balance.* Modest-sized businesses maintain hundreds of accounts for their various assets, liabilities, owners' equity, revenue and expenses. Larger businesses keep thousands of accounts, and very large businesses may keep more than 10,000 accounts. In contrast, external financial statements, tax returns and internal accounting reports to managers contain a relatively small number of accounts. For example, a typical external balance sheet reports only 20 to 25 accounts, and a typical income tax return contains less than 100 accounts.

   The accountant takes the adjusted trial balance and telescopes similar accounts into one summary amount that is reported in a financial report or tax return. For example, a business may keep hundreds of separate stock accounts, every one of which is listed in the adjusted trial balance. The accountant collapses all these accounts into one summary stock account that is presented in the external balance sheet of the business.

   In short, the large number of specific accounts listed in the adjusted trial balance is condensed into a comparatively small number of accounts that are reported in financial statements and tax returns. In grouping the accounts, the accountant should comply with established financial reporting standards and income tax requirements.

6. ***Close the books* – bring the bookkeeping for the fiscal year just ended to a close and get things ready to begin the bookkeeping process for the coming fiscal year.**

   Books is the common term for *accounts*. A business's transactions are a constant stream of activities that don't end tidily on the last day of the year, which can make preparing financial statements and tax returns challenging. The business has to draw a clear line of demarcation between activities for the year (the 12-month accounting period) ended and the year yet to come by *closing the books* for one year and starting with fresh books for the next year.

The business may have an *accounting manual* that spells out in great detail the specific accounts and procedures for recording transactions. But all businesses change over time, and they occasionally need to review their accounting system and make revisions. Companies do not take this task lightly; discontinuities in the accounting system can be major shocks and have to be carefully thought out. Nevertheless, bookkeeping and accounting systems can't remain static for very long. If these systems were never changed, bookkeepers would still be sitting on high stools making entries with quill pens and ink in leather-bound ledgers.

Managing the Bookkeeping and Accounting System

In our experience, far too many business managers either ignore their bookkeeping and accounting systems or take them for granted – unless something obvious goes wrong. The managers assume that if the books are in balance, then everything is okay. The section ‘Recording transactions using debits and credits’, later in this chapter, covers just exactly what ‘the books being in balance’ means – it does *not* necessarily mean that everything is okay.

To determine whether your bookkeeping system is up to scratch, check out the following sections, which, taken as a whole, provide a checklist of the most important elements of a good system.

Categorise your financial information: The chart of accounts

Suppose that you’re the accountant for a company and you’re faced with the daunting task of preparing the annual income tax return for the business. This demands that you report the following kinds of expenses (and this list contains just the minimum!):

- Advertising
- Bad debts
- Charitable contributions
- Compensation of directors
- Cost of goods sold
- Depreciation
- Employee benefits
- Interest
- Pensions and profit-sharing plans
- Rents

- Repairs and maintenance
- Salaries and wages
- Taxes and licenses

You must provide additional information for some of these expenses. For example, the cost of goods sold expense is determined in a schedule that also requires stock cost at the beginning of the year, purchases during the year, cost of labour during the year (for manufacturers), other costs and stock cost at year-end.

Where do you start? Well, if it's March 1 and the tax return deadline is March 15, you start by panicking – unless you were smart enough to think ahead about the kinds of information your business would need to report. In fact, when your accountant first designs your business's accounting system, he or she should dissect every report to managers, the external financial statements and the tax returns, breaking down all the information into categories such as those we just listed.

For each category, you need an *account*, a record of the activities in that category. An account is basically a focused history of a particular dimension of a business. In bookkeeping this means a basic category of information in which the financial effects of transactions are recorded and which serves as the source of information for preparing financial statements, tax returns and reports to managers.

The term *general ledger* refers to the complete set of accounts established and maintained by a business. The *chart of accounts* is a term used to describe a formal index of these accounts – the complete listing and classification of the accounts used by the business to record its transactions. *General ledger* usually refers to the actual accounts and often to the balances in these accounts at some particular time.

The chart of accounts, even for a relatively small business, normally contains 100 or more accounts. Larger business organisations need thousands of accounts. The larger the number, the more likely that the accounts are given number codes according to some scheme – all assets may be in the 100–300 range, all liabilities in the 400–500 range and so on.

As a business manager, you should make sure that the person in charge of accounting (or perhaps an outside chartered accountant) reviews the chart of accounts periodically to determine whether the accounts are up-to-date and adequate for the business's needs. Over time, income tax rules change, the company may go into new lines of business, the company could decide to offer additional employee benefits and so on. Most businesses are in constant flux, and the chart of accounts has to keep up with these changes.

Standardise source document forms and procedures

Businesses move on paperwork. Whether placing an order to buy products, selling a product to a customer or determining the earnings of an employee for the month – virtually every business transaction needs paperwork, known as *source documents.* Source documents serve as evidence of the terms and conditions agreed upon by the business and the other person or organisation that it's dealing with. Both parties receive some kind of source document. For example, for a sale at a cash register, the customer gets a sales receipt, and the business keeps a running record of all transactions in the register.

Clearly, an accounting system needs to standardise the forms and procedures for processing and recording all normal, repetitive transactions and should control the generation and handling of these source documents.

From the bookkeeping point of view, these business forms and documents are very important because they provide the input information needed for recording transactions in the business's accounts. Sloppy paperwork leads to sloppy accounting records, and sloppy accounting records just won't do when the time comes to prepare tax returns and financial statements.

Check out a business office-supply store to see the kinds of forms that you can buy right off the shelf. You can find many – maybe all – of the basic forms and documents that you need for recording business transactions, although most firms have to design at least some of their own forms. Also, personal computer accounting software packages (see Appendix B for more detail) provide templates for common business forms.

Don’t be penny-wise and pound-foolish: The need for competent, trained personnel

What good is meticulously collecting source documents if the information on those documents isn’t entered into your system correctly? You shouldn’t try to save a few pounds by hiring the lowest-paid people you can find. Bookkeepers and accountants, like all other employees in a business, should have the skills and knowledge needed to perform their functions. No-brainer, right? Well, determining what that level is *can* be difficult. Here are some guidelines for choosing the right people to enter and manipulate your business’s data and for making sure that those people *remain* the right people:

- **University degree:** Many accountants in business organisations have a degree in accounting. However, as you move down the accounting department you find that more and more employees do not have a degree and perhaps even haven't taken any courses in accounting.
- **ACA, ACCA or CIMA:** The main professional accounting credentials are: ACA sponsored by the Institute of Chartered Accountants; ACCA sponsored by the Association of Chartered Certified Accountants; and CIMA sponsored by the Chartered Institute of Management Accountants. All of these qualifications are evidence that the person has passed tough exams and has a good understanding of business accounting and income tax. The Association of Chartered Certified Accountants (www.accaglobal.com, click on 'Public Interest' and then on 'Find an Accountant') and the Institute of Chartered Accountants (www.icaewfirms.co.uk) have online directories of qualified accountants. You can search these directories by name (useful if you have a personal recommendation from a colleague you respect), location (handy if you just want someone nearby), the business sector you're in (helpful for tapping into specialist skills) or any specific accountancy skills or knowledge you're looking for.
- **Accounting technicians:** These people assist chartered accountants in their work, or can join a chartered institute themselves after further study. The Association of Accounting Technicians' website (www.aat.org.uk, then click on 'Employers' and 'Recruitment') provides guidance on pay structures and tips on how to find an accountant.
- **Bookkeepers:** These are the lowest-cost players in this game. They perform the basic entry work covering anything from simply recording the transactions in your

books through to producing accounts, preparing the VAT return or doing the Payroll. The International Association of Book-keepers (www.iab.org.uk) and the Institute of Certified Bookkeepers (www.book-keepers.org) offer free matching services to help small businesses find a bookkeeper to suit their particular needs.

- **Continuing education:** Many short-term courses, e-learning and home-study programmes are available at very reasonable costs for keeping up on the latest accounting developments. Accountancy bodies that give practising certificates, which allow accountants to work with businesses in public practice, will expect them to take continuing education in approved courses in order to keep their practising certificates.
- **Integrity:** What's possibly the most important quality to look for is also the hardest to judge. Bookkeepers and accountants need to be honest people because of the amount of control they have over your business's financial records.

Protect the family jewels: Internal controls

Every accounting system should establish and vigorously enforce *internal controls* – basically, additional forms and procedures over and above what's strictly needed to move operations along. These additional controls serve to deter and detect errors (honest mistakes) and all forms of dishonesty by employees, customers, suppliers and even managers themselves. Internal controls are like a public weighbridge that makes sure that a heavy goods vehicle's load doesn't exceed the limits and that the vehicle has a valid licence. You're just checking that your staff are playing by the rules.

For example, to prevent or minimise shoplifting, most retailers now have video surveillance, tags that set off the alarms if the customer leaves the store with the tag still on the product, and so on. Likewise, a business has to implement certain procedures and forms to prevent, as much as possible, any theft, embezzlement, scams and fraud (and simple mistakes) by its own employees and managers.

In our experience, smaller businesses tend to think that they're immune to embezzlement and fraud by their loyal and trusted employees. Yet a recent study found that small businesses are hit the hardest by fraud and usually can least afford the consequences. Your business, too, should put checks and balances into place to discourage dishonest practices and to uncover any fraud and theft as soon as possible. For example, virtually every retailer that deals with the general public installs protection against shoplifting. Likewise, every business should guard against 'internal shoplifting' or fraud by its employees and managers.

Keep the scales in balance with double-entry accounting

A business needs to be sure that *both* sides of the economic exchange are recorded for all its transactions. Economic exchanges involve a give and take, or something given for something received. Businesses (and other entities as well) use the *double-entry accounting method* to make sure that both sides of their transactions are recorded and to keep their books in balance. This method, which has been used for hundreds of years, involves recording certain changes as debits and the counterbalancing changes as credits. See ‘Double-Entry Accounting for Non-Accountants,’ later in this chapter, for more details.

Check your figures: End-of-period procedures checklist

Like a pilot before take-off, an accountant should have a clear checklist to follow at the end of each period and especially at the end of the accounting year. Two main things have to be done at the end of the period:

- **Normal, routine *adjusting entries* for certain expenses:** For example, depreciation isn’t a transaction as such and therefore hasn’t been recorded as an expense in the flow of transactions recorded in the day-to-day bookkeeping process. (Chapter 6 explains depreciation expense.) Similarly, certain other expenses and some revenues may not have been associated with a specific transaction and will not have been recorded. These kinds of adjustments are necessary for providing complete and accurate reports.
- ***Careful sweep of all matters* to check for other developments that may affect the accuracy of the accounts:** For example, the company may have discontinued a product line. The remaining stock of these products may have to be removed from the asset account, with a loss recorded in the period. Or the company may have settled a long-standing lawsuit, and

the amount of damages needs to be recorded. Layoffs and severance packages are another example of what the chief accountant needs to look for before preparing reports.

Lest you still think of accounting as dry and dull, let us tell you that end-of-period accounting procedures can stir up controversy of the heated-debate variety. These procedures require that the accountant make decisions and judgments that upper management may not agree with. For example, the accountant may suggest recording major losses that would put a big dent in the profit for the year or cause the business to report a loss. The outside auditor (assuming that the business has an audit of its financial statements) often gets in the middle of the argument. These kinds of debates are precisely why you business managers need to know some accounting: to hold up your end of the argument and participate in the great sport of yelling and name-calling – strictly on a professional basis, of course.

Keep good records: Happy audit trails to you!

The happy trails that accountants like to walk are called *audit trails.* Good bookkeeping systems leave good audit trails. An audit trail is a clear-cut path of the sequence of events leading up to an entry in the accounts; an accountant starts with the source documents and follows through the bookkeeping steps in recording transactions to reconstruct this path. Even if a business doesn't have an outside accountant do an annual audit, the firm's management accountant has frequent occasion to go back to the source documents and either verify certain information in the accounts or reconstruct the information in a different manner. For example, suppose that a salesperson is claiming some suspicious-looking travel expenses; the accountant would probably want to go through all this person's travel and entertainment reimbursements for the past year.

If HM Revenue and Customs comes in for a field audit of your business, you'd better have good audit trails to substantiate all your expense deductions and sales revenue for the year. Rules exist about saving source documents for a reasonable period of time (usually at least five years) and having a well-defined process for making bookkeeping entries and keeping accounts. Think twice before throwing away source documents. Also, ask your accountant to demonstrate, and lay out for your inspection, the audit trails for key transactions – such as cash collections, sales, cash disbursements, stock purchases and so on. Even in computer-based accounting systems, the importance of audit trails is recognised. Well-designed computer programs provide the ability to backtrack through the sequence of steps in the recording of specific transactions. The HM Revenue and Customs website (go to www.hmrc.gov.uk and click on 'Businesses and corporations') gives you the lowdown on which books to keep and for how long. You can search for info about any unlisted topics by using the search panel at the top of the homepage.

Look out for unusual events and developments

Business managers should encourage their accountants to be alert to anything out of the ordinary that may require attention. Suppose that the debtor balance for a particular customer is rapidly increasing – that is, the customer is buying more and more from your company on credit but isn't paying for these purchases quickly. Maybe the customer has switched more of his or her company's purchases to your business and is buying more from you only because he or she is buying less from other businesses. But maybe the customer is planning to stuff your business and take off without paying his or her debts. Or maybe the customer is secretly planning to go into bankruptcy soon and is stockpiling products before the company's credit rating heads south. To some extent, accountants have to act as the eyes and ears of the business. Of course, that's one of your main functions as business manager, but your accounting staff can play an important role as well.

Design truly useful accounting reports for managers

We have to be careful in this section; we have strong opinions on this matter. We have seen too many hit-and-miss accounting reports to managers – difficult to decipher and not very useful or relevant to the manager's decision-making needs and control functions.

Part of the problem lies with the managers themselves. As a business manager, have you told your accounting staff what you need to know, when you need it, and how to present it in the most efficient manner? Probably not. When you stepped into your position you probably didn't hesitate to rearrange your office and maybe even insisted on hiring your own support staff. Yet you most likely lay down like a lapdog regarding your accounting reports. Maybe you've assumed that the reports have to be done a certain way and that arguing for change is no use.

On the other hand, accountants bear a good share of the blame for the poor reports. Accountants should proactively study the manager's decision-making responsibilities and provide the information that is most useful, presented in the most easily digestible manner.

In designing the chart of accounts, the accountant should also keep in mind the type of information needed for management reports. To exercise control, managers need much more detail than what's reported on tax returns and external financial statements. And, as Chapter 9 explains, expenses should be regrouped into different categories for management decision-making analysis. A good chart of accounts looks to both the external and the internal (management) needs for information.

TIP

So what's the answer for a manager who receives poorly formatted reports? Demand a report format that suits your needs! See Chapter 9 for a useful profit analysis model (and make sure that your accountant reads that chapter as well).

Double-Entry Accounting for Non-Accountants

A business is a *two-sided* entity. It accumulates assets on one side – by borrowing money, persuading investors to put money in the business as owners, purchasing assets on credit and making profit. Profit (net income) is essentially an increase in assets, not from increasing liabilities and not from additional capital infusion from owners, but rather as the net result of sales revenue less expenses. Assets don't fall on a business like manna from heaven. Assets have *sources*, and these sources are *claims* of one sort or another on the assets of a business. A business needs to keep track of the sources of assets, according to the type of claim each source has against the assets. This is precisely the reason for and nature of *double-entry accounting.*

The two-sided nature of a business entity and its activities

In a nutshell, double-entry accounting means *two-sided* accounting. Both the assets of a business and the sources of and claims on its assets are accounted for. Suppose that a business reports £10 million in total assets. That means the total sources of and claims on its assets are also reported at a total of £10 million. Each asset source has a different type of claim. Some liabilities charge interest and some don't; some have to be paid soon, and other loans to the business may not come due for five or ten years. Owners' equity may be mainly from capital invested by the owners and very little from retained earnings (profit not distributed to the owners). Or the mix of owners' equity sources may be just the reverse.

The sources of and claims on the assets of a business fall into two broad categories: *liabilities* and *owners' equity.* With a few technical exceptions that we won't go into, the amount of liabilities that the business reports are the amounts that will be paid to the creditors at the maturity dates of the liabilities. In other words, the amounts of liabilities are definite amounts to be paid at certain future dates.

In contrast, the amounts reported for owners' equity are *historical* amounts, based on how much capital the owners invested in the business in the past and how much profit the business has recorded. Owners' equity, unlike the liabilities of a business, has no maturity date at which time the money has to be returned to the owners. When looking at the amount of owners' equity reported in a balance sheet, don't think that this amount could be taken out of the business. Owners' equity is tied up in the business indefinitely.

So one reason for double-entry accounting is the two-sided nature of a business entity – assets are on one side and the sources of and claims on assets are on the other side. The second reason for double-entry accounting is the *economic exchange* nature of business activities, referring to the give-and-receive nature of the transactions that a business engages in to pursue its financial objectives. Consider a few typical transactions:

- A business borrows £10 million. It receives money, so the company's cash increases. In exchange, the business promises to return the £10 million to the lender at some future date so the company's debt increases. Interest on the loan is paid in exchange for the use of the money over time.

- The business buys products that it will later resell to its customers: It gives money for the products (the company's cash decreases) and receives the products (the company's stock increases).
- The business sells products: It receives cash or promises of cash to come later (the company's debtors increase), and it gives the products to the customer (the company's stock decreases). Of course, the business should sell the products for more than cost. The excess of the amount received over product cost is called *gross profit*, from which many other expenses have to be deducted. (Chapter 5 explains the profit-making transactions leading to bottom-line profit or loss.)

Recording transactions using debits and credits

Using *debits and credits* is a marvellous technique for making sure that both sides of exchanges are recorded and for keeping both sides of the accounting equation in balance. The recording of every transaction requires the same value for the debits on one side and the credits on the other side. Just think back to maths class in your schooldays: What you have on one side of the equal sign (in this case, in the accounting equation) must equal what you have on the other side of the equal sign.

See the table for how debits and credits work in the balance sheet accounts of a business. The rules of debits and credits:

Changes	***In Assets***	***In Liabilities and Owners' Equities***
Increases	Debit	Credit
Decreases	Credit	Debit

Note: Sales revenue and expense accounts, which aren't listed, also follow debit and credit rules. A revenue item increases owners' equity (thus is a credit), and an expense item decreases owners' equity (thus is a debit).

As a business manager, you don't need to know all the mechanics and technical aspects of using debits and credits. Here's what you do need to know:

- **The basic premise of the accounting equation:** Assets equal the sources of the assets and the claims on the assets. That is, the total of assets on the one side should equal the sum of total liabilities and total owners' equity on the other side.
- **The important difference between liabilities and owners' equity accounts:** Liabilities need to be paid off at definite due dates in the future. Owners' equity has no such claims for definite payments at definite dates. As such, these two accounts must be kept separate.
- **Balanced books don't necessarily mean correct balances:** If debits equal credits, the entry for the transaction is correct as far as recording equal amounts on both sides of the transaction. However, even

if the debits equal the credits, other errors are possible. The bookkeeper may have recorded the debits and credits in a wrong account, or may have entered wrong amounts, or may have missed recording an entry altogether. Having balanced books simply means that the total of accounts with debit balances equals the total of accounts with credit balances. The important thing is whether the books (the accounts) have *correct* balances, which depends on whether all transactions and other developments have been recorded and accounted for correctly.

Making Sure the Books Don't Get Cooked

Cooked is a catch-all term; we're using the term in its broadest sense to include any type of dishonest, unethical, immoral or illegal practice. Our concern here is with the effects of distortion on a business's accounting records, not with the broader social and criminal aspects of fraudulent accounting – which are very serious, of course, but which are outside the scope of this book.

A business should capture and record faithfully all transactions in its accounting records. Having said this, we have to admit that some business activities are deliberately *not* accounted for or are accounted for in a way that disguises their true nature. For example, *money laundering* involves taking money from illegal sources (such as drug dealing) and passing it through a business to make it look legitimate – to give the money a false identity. This money can hardly be recorded as ‘revenue from drug sales’ in the accounts of the business.

Fraud occurs in large corporations and in one-owner/manager-controlled small businesses – and every size business in between. Some types of fraud are more common in small businesses, including *sales skimming* (not recording all sales revenue, to deflate the taxable income of the business and its owner) and the recording of personal expenses through the business (to make these expenses deductible for income tax). Some kinds of fraud are committed mainly by large businesses, including paying bribes to public officials and entering into illegal conspiracies to fix prices or divide the market. The purchasing managers in any size business can be tempted to accept kickbacks and under-the-table payoffs from vendors and suppliers.

We should mention another problem that puts accountants in the hot seat: In many situations, two or more businesses are controlled by the same person or the same group of investors. Revenue and expenses can be arbitrarily shifted among the different business entities under common control. For one person to have a controlling ownership interest in two or more businesses is perfectly legal, and such an arrangement often makes good business sense. For example, a retail business rents a building from a property business, and the same person is the majority owner of both businesses. The problem arises when that person arbitrarily sets the monthly rent to shift profit between the two businesses; a high rent generates more profit for the property business and lower profit for the retail business. This kind of manoeuvre may even be perfectly legal, but it raises a fundamental accounting issue.

Readers of financial statements are entitled to assume that all activities between the business and the other parties it deals with are based on what's called *arm's-length bargaining*, meaning that the business and the other parties have a purely business relationship. When that's not the case, the financial report should – but usually doesn't – use the term *related parties* to describe persons and organisations who are not at arm's length with the business. According to financial reporting standards, your accountant should advise you, the business manager, to disclose any substantial related-party transactions in your external financial statements.

In short, fraud occurs in the business world. Most of these schemes require *cooking the books* – which means altering entries in the accounts to cover the fraud or simply not recording certain entries that should be recorded. If you saw an expense account called *bribes,* you would tend to be a little suspicious, but unethical bookkeepers and accountants are usually a tad cleverer than that. You can find several tips on uncovering and preventing fraud in ‘Managing the Bookkeeping and Accounting System’ earlier in this chapter.

When the books have been cooked, the financial statements prepared from the accounts are distorted, incorrect and probably misleading. Lenders, other creditors and the owners who have capital invested in the business rely on the company’s financial statements. Also, a business’s managers and board of directors (the group of people who oversee a business enterprise) may be misled – assuming that they’re not a party to the fraud, of course – and may also have liability to third-party creditors and investors for their failure to catch the fraud. Creditors and investors who end up suffering losses have legal grounds to sue the managers and directors (and perhaps the auditors who did not catch the fraud) for damages suffered.

The Sarbanes-Oxley Act, a new set of rules and regulations designed to ensure truthful accounting in companies listed on the American stock market, came into force in 2002. Chapter 1 gives you information about Sarbanes-Oxley.

Chapter 3

Taxes, Taxes and More Taxes

In This Chapter

- Paying taxes as an employer and a property owner
- Putting on your tax collector hat and collecting Value Added Tax (VAT)
- Determining how much of business profit goes to the government
- Allowing company tax methods to override good accounting methods
- Looking at the different ways company tax works for different business structures

As an employer, a business pays taxes. As a property owner or occupier, a business pays taxes. As a seller of goods and services, a business collects Value Added Tax paid by customers and remits the amounts to the government's Customs and Excise Department. And, of course, a business, or its owners, must pay corporate income tax. Yikes! Is there no escaping the tax millstone?

Nope, afraid not (short of resorting to illegal activity or a sly move to another country – you'll have to find another book to tell you about those options). But you can take advantage of the many options in tax laws that can minimise how much you pay and delay your payment (a perfectly legal strategy known as *tax avoidance*). This chapter starts you on your way by explaining the various types of taxation that a business faces.

We say that this chapter '*starts* you on your way' because we can't possibly provide you with exhaustive detail in one chapter. And besides, no one can give you good tax advice without first looking at your specific situation – consult a professional tax expert for that.

Taxing Wages and Property

Even if you don't earn a profit in your business, you still have to pay certain taxes. Unlike corporation tax, which is a *contingent* or *conditional* tax that depends on whether a business earns taxable income for the year, the two major types of non-income taxes – *employer payroll taxes* and *business rates* – always have to be paid. (See 'Taxing Your Bottom Line: Company Taxes,' later in this chapter, for more about income tax.)

Putting the government on the payroll: Employer taxes

In addition to deducting income tax from employees' wages and remitting those amounts to the proper government agencies, businesses need to pay National Insurance for all employees, yourself included. (Actually, National Insurance isn't really a tax, but we won't get technical.)

National Insurance

Most people don't realise that they usually pay less than half of their National Insurance bill – the employer picks up the rest of the tab. The idea is that the burden should be shared almost evenly, but with the employer generally picking up a little more of the tab.

We don't want to get into a debate about the National Insurance system and the financial problems it's facing; we'll just say that the amount you'll pay in National Insurance almost certainly won't diminish in the future. Here's an idea of what a business pays in National Insurance: In 20011/12, the first £5,315 of annual wages were exempt from any National Insurance charges. Then, up to a ceiling of £42,475, the employer pays 13.8 per cent.

Employment tax

Employing people requires you to manage a PAYE (Pay As You Earn) system. If your business is a limited company, the owner (you) is also liable for PAYE. You will also have to deduct National Insurance. Both these tasks will involve some additional record keeping, as, once again, owner-managers are being asked to act as unpaid tax collectors. There are serious penalties for getting it wrong.

PAYE

Income tax is collected from employees through the PAYE system, or Pay As You Earn. The employee's liability to income tax is collected as it is earned instead of by tax assessment at some later date. If the business is run as a limited company, then the directors of the company are employees. PAYE must be operated on all salaries and bonuses paid to them, yourself included.

The way to an employee's heart is through the payroll department

Remember the first time you received a real pay cheque? Your jaw dropped when you compared the *gross wages* (the amount before deductions) and the *net,* or *take-home pay* (the amount you actually received), right? A business's accountants need to track how much of the following, by law, to deduct from employees' pay cheques:

- National Insurance.
- Pay As You Earn (PAYE) taxes on income, which go to the Government.
- Other, non-tax-related withholdings that the employee agrees to (such as union dues, pension plan contributions, and health insurance costs paid by the employee).
- Other non-tax-related withholdings required by a court order (for example, a business may be ordered to withhold part or all of an employee's wages and remit the amount to a legal agency or a creditor to which the employee owes money).

For all these deductions, a business serves as a collection agent and remits the appropriate amount of wages to the appropriate party. As you can imagine, this task requires lots of additional accounting and record-keeping.

HM Revenue and Customs now issues booklets in reasonably plain English explaining how PAYE works. The main documents you need to operate PAYE are:

- **Form P11,** a deduction working sheet for each employee.
- **The PAYE Tables.** There are two books of tax tables in general use, which are updated in line with the prevailing tax rates.
  - Pay Adjustment Tables show the amount that an employee can earn in any particular week or month before the payment of tax.
  - Taxable Pay Tables show the tax due on an employee's taxable pay.
- **Form P45,** which is given to an employee when transferring from one employment to another.
- **Form P46,** which is used when a new employee does not have a P45 from a previous employment (for example, a school-leaver starting work for the first time).
- **Form P60,** which is used so that the employer can certify an employee's pay at the end of the income tax year in April.
- **Form P35,** the year-end declaration and certificate. This is used to summarise all the tax and National Insurance deductions from employees for the tax year.
- **Form P6,** the tax codes advice notice issued by the Inspector of Taxes telling you which tax code number to use for each employee.

You can find tables giving details of PAYE and NIC rates and limits for the current tax year, for every conceivable category, at the HM Revenue and Customs website (www.hmrc.gov.uk/employers/).

Taxing everything you can put your hands on: Property taxes

Businesses and other occupiers of non-domestic properties pay Non-Domestic Rates (also known as Business Rates) to directly contribute towards the costs of local authority services. Non-domestic properties are business properties such as shops, offices, warehouses and factories, and any other property that is not classed as domestic property. In some cases, properties may be used for both domestic and non-domestic purposes (for example, a shop with a flat above it), in which case both council tax, the tax charged on personal properties, and Business Rates will be charged.

Apart from the few lucky properties such as churches, agricultural land, sewers, public parks, certain property used for disabled people, and swinging moorings for boats, which are all exempt from Business Rates, each non-domestic property has a rateable value. The valuation officers of the Valuation Office Agency (VOA) set the rateable values. The VOA is a part of HM Revenue and Customs. It draws up and maintains a full list of all rateable values.

The Valuation Office Agency carries out a revaluation every five years so that the values in the rating lists can be kept up-to-date. The total amount of Business Rates collected does not change except to reflect inflation, but revaluations make sure that this is spread fairly between ratepayers. The most recent revaluation took place in April 2005.

The rateable value broadly represents the yearly rent the property could have been let for on the open market on a particular date. Your local council works out your Business Rates bill by multiplying your rateable value by the multiplier or ‘poundage’ which the Government sets from 1 April each year for the whole of England. For example, if the multiplier (which is often called the uniform business rate or UBR) was set at 43.3p (43.7 in Central London) and your rateable value was £10,000, the local authority would multiply this by 43.3p and your 'property tax' bill for the year would be £4,330.

REMEMBER

Your property may qualify for exemption under various national and local regulations or may be eligible for special reductions.

You may be able to get relief if one of the following applies to you:

- **Your business is small.** A UBR of 42.6p applies to certain businesses with rateable values below £6,000. The rules are complex and operate on a sliding scale.
- **Your property is empty and unused.** For the first three months that a business property is empty, councils don't charge Business Rates for the property. For industrial and warehouse property the rate-free period is six months. After this, a 100 per cent business rate charge usually applies.
- **Your business is in a rural village with a population below 3,000.** The types of business that qualify for this relief are:
    - The only village general store or post office as long as it has a rateable value of up to £8,500.
    - A food shop with a rateable value of up to £8,500.
    - The only village pub and the only petrol station as long as it has a rateable value of up to £12,500.

These premises are entitled to a 50 per cent reduction in the Business Rates bill, or more if the council believes you need it.

If you are a business in a qualifying rural village with a rateable value of up to £16,500, your local council may decide to give you up to 100 per cent relief, as long as your business is of benefit to the community.

- **You are suffering severe hardship and cannot pay your Business Rates bill.** Your local council may decide to give you up to 100 per cent relief – the decision is up to them. They normally only do this in extreme cases of hardship and for businesses that are particularly important to the local community. This takes account of the fact that local council tax payers will cover part of the cost of the relief.

If you think you may qualify for any of these types of relief, you should contact the Business Rates section of your local council for more information and advice on how to apply.

Working from home

If you work from home, your local council may charge Business Rates for the part of the property used for work, and you will have to pay council tax for the rest of the property (although your property's valuation band may change). It will depend on the circumstances of each case and you should ask your local office of the Valuation Office Agency for advice.

Property taxes can take a big chunk out of a business's profit. In large organisations, an in-house accountant who deals with property taxes and knows the tax law language and methods is responsible for developing strategies to minimise property taxes. Small-business owners may want to consult a rating adviser. Members of the Royal Institution of Chartered Surveyors (RICS) and the Institute of Revenues Rating and Valuation (IRRV) are qualified and are regulated by rules of professional conduct designed to protect the public from misconduct.

You can find details of these organisations and their members on their websites:

- RICS – www.rics.org
- IRRV – www.irrv.org.uk

You can find the latest information on business rates on the official Government website at www.businesslink.gov.uk.

Before you employ a rating adviser, you should check that they have the necessary knowledge and expertise, as well as appropriate indemnity insurance. You should also be wary of false or misleading claims.

Getting to Grips with Value Added Tax

Most governments, and the UK Government is no exception, levy *sales taxes* on certain products and services sold within their jurisdictions. In the UK this tax is known as the Value Added Tax (VAT). The final consumer of the product or service pays the VAT – in other words the tax is tacked onto the product's price tag at the very end of the economic chain. The business that is selling the product or service collects the VAT and remits it to the appropriate tax agency (HM Revenue and Customs in the UK). Businesses that operate earlier in the economic chain (that is, those that sell products to other businesses that in turn resell the products) generally do not end up paying VAT but simply collect it and pass it on.

For example, when you run to your local chemist for some headache pills after all this tax business, you pay the chemist the cost of the pills plus VAT. But the chemist can reclaim the VAT it paid to the wholesaler (and so on, back along the retail chain). Only you, the final consumer, pays the VAT. (Lucky you!)

VAT is a complicated tax. Currently, you must register if your taxable turnover, that is, sales (not profit), exceeds £73,000 in any 12-month period, or looks as though it might reasonably be expected to do so. This rate is reviewed each year in the budget and is frequently changed. (The UK is significantly out of line with many other countries in Europe, where VAT entry rates are much lower.) The general rule is that all supplies of goods and services are taxable at the standard rate (20 per cent) unless they are specifically stated by the law to be zero-rated or exempt. In deciding whether your turnover exceeds the limit you have to include the zero-rated sales (things like most foods, books and children's clothing), as they are technically taxable; it's just that the rate of tax is 0 per cent. You leave out exempt items. As a designated tax collector, the business does not pay VAT on goods and services it buys from other VAT registered businesses that are destined to be sold to its customers.

If you are a small business owner/manager, be aware that if you overlook this role imposed on the business by the government, you're still responsible for paying the tax over to the government. Suppose you make a sale for £100 but don't add the £20.00 VAT, which is the rate currently applying in the UK. Big Brother says you did collect the VAT, whether you think you did or not. So you still have to pay the government the VAT element in the £100 (£16.67), which leaves you with only £83.33 in sales revenue.

There are three free booklets issued by HM Revenue and Customs: a simple introductory booklet called *Should you be registered for VAT?* and two more detailed booklets called *General Guide* and *Scope and Coverage*. If in doubt (and the language is not easy to understand) ask your accountant or the local branch of HM Revenue and Customs; after all, they would rather help you to get it right in the first place than have to sort it out later when you have made a mess of it.

Each quarter, you have to complete a return, which shows your purchases and the VAT you paid on them, and your sales and the VAT you collected on them. The VAT paid and collected are offset against each other and the balance sent to HM Revenue and Customs. If you have paid more VAT in any quarter than you have collected, you will get a refund. For this reason it sometimes pays to register if you don't have to – if you're selling mostly zero-rated items for example; also, being registered for VAT may make your business look more professional and less amateurish to your potential customers.

Tracking and recording Value Added Tax is a big responsibility for many businesses, especially if the business operates across several European countries. Having well-trained accounting staff manage this side of the business is well worth the cost. You can check the HM Revenue and Customs website for the latest rules (go to www.hmrc.gov.uk and click on 'VAT').

You can find a useful VAT calculator on the small business portal www.bytestart.co.uk. Click on 'Tax and Accounting' and then on 'VAT Calculator'.

Taxing Your Bottom Line: Company Taxes

This chapter focuses on the tax dimensions of business entities. Chapter 4 presents a basic income tax model for individuals (see the section 'The Accounting Vice You Can't Escape').

Every business must determine its annual *taxable income*, which is the amount of profit subject to corporate tax or income tax if the business is not a limited company. To determine annual *taxable income*, you deduct certain allowed expenses from gross income. Corporation tax law rests very roughly on the premise that all income is taxable unless expressly exempted, and nothing can be deducted unless expressly allowed.

When you read a profit-and-loss account that summarises a business's sales revenue and expenses for a period and ends with bottom-line profit, keep in mind that the accrual basis of accounting has been used to record sales revenue and expenses. The accrual basis gives a more trustworthy and meaningful profit number. But accrual-based sales revenue and expense numbers are not cash inflows and outflows during the period. So the bottom-line profit does not tell you the impact on cash from the profit-making activities of the business. You have to convert the revenue and expense amounts reported in the profit-and-loss account to a cash basis in order to determine the net cash increase or decrease. Well, actually, you don't have to do this – the cash flow statement does this for you, as Chapter 7 explains.

Although you determine your business's taxable income as an annual amount, you don't wait until you file your tax return to make that calculation and payment. Instead, corporation tax law requires you to estimate your corporation income tax for the year and, based on your estimate, to make two half-yearly instalment payments on your corporation tax during the year, one at the end of January and one at the end of July. Rather than calculating the tax due yourself, you can rely on HM Revenue and Customs to do the sums for you if you send in a completed tax return before the 30 September for the year in question. When you file the final tax return – with the official, rather than the estimated, taxable income amount – after the close of the year, you pay any remaining amount of tax you owe or claim a refund if you have overpaid your corporation tax during the year. If you grossly underestimate your taxable income for the year and thus end up having to pay a large amount of tax after the end of the year, you probably will owe a late payment penalty. After your first year in business, the tax you have to pay will be based on your profits for the previous tax year. A tax year runs from 6 April to 5 April.

A word on cash basis accounting for Value Added Tax

Cash basis accounting (also known as *chequebook accounting*) isn't generally acceptable in the world of business, but is permitted by Value Added Tax law for some businesses. To use cash basis VAT accounting, a business must keep these factors in mind:

- Cash accounting is open to you if you are a registered trader with an expected turnover not exceeding **£1,350,000** in the next 12 months. There is a 25 per cent tolerance built into the scheme. This means that once you are using cash accounting, you can normally continue to use it until the annual value of your taxable supplies reaches **£1,600,000**.

- The main accounting record you must keep will be a cash book summarising all payments made and received, with a separate column for the relevant VAT. You will also need to keep the corresponding tax invoices and ensure that there is a satisfactory system of cross-referencing.

- These VAT records must be kept for six years, unless you have agreed upon a shorter period with your local VAT office.

- The longer the time lag between your issuing sales invoices and receiving payment from your customers, the more benefit cash accounting is likely to be to you. If you are usually paid as soon as you make a sale (e.g. if you use a retail scheme) you will normally be worse off under cash accounting. The same applies to the situation where you regularly receive re-payments of VAT (e.g. because you make zero-rated supplies).

- One major advantage of the scheme is that it simplifies your bookkeeping requirements, and many businesses can be controlled simply by using an appropriately analysed cash book.

For the great majority of businesses, cash basis accounting is not acceptable, either for reporting to HM Revenue and Customs or for preparing financial statements. So this last advantage of cash-based VAT accounting is illusory. This method falls short of the information needed for even a relatively small business. Accrual basis accounting, described in Chapters 5 and 6, is the only real option for most businesses. Even small businesses that don't sell products should carefully consider whether cash basis is adequate for:

- Preparing external financial statements for borrowing money and reporting to owners.

- Dividing profit among owners.

For all practical purposes, only sole proprietorships (one-owner businesses) that sell just services and no products can use cash basis VAT accounting. Other businesses must use the accrual basis – which provides a much better income statement for management control and decision-making, and a much more complete picture of the business's financial condition.

You must keep adequate accounting records to determine your business's annual taxable income. If you report the wrong taxable income amount, you can't plead that the bookkeeper was incompetent or that your accounting records were inadequate or poorly organised – in fact, the good old tax man may decide that your poor accounting was intentional and is evidence of income tax evasion. If you under-report your taxable income by too much, you may have to pay interest and penalties in addition to the tax that you owe.

When we talk about adequate accounting records, we're not talking about the accounting *methods* that you select to determine annual taxable income – Chapter 13 discusses choosing among alternative accounting methods for certain expenses. After you've selected which accounting methods you'll use for these expenses, your bookkeeping procedures must follow these methods faithfully. Choose the accounting methods that minimise your current year's taxable income – but make sure that your bookkeeping is done accurately and on time and that your accounting records are complete. If your business's income tax return is audited, HM Revenue and Customs agents first look at your accounting records and bookkeeping system.

Furthermore, you must stand ready to present evidence for expense deductions. Be sure to hold on to receipts and other relevant documents. In an HM Revenue and Customs audit, the burden of proof is on *you*. HM Revenue and Customs don't have to disprove a deduction; you have to prove that you were entitled to the deduction. *No evidence, no deduction* is the rule to keep in mind.

The following sections paint a rough sketch of the main topics of business income taxation. (We *don’t* go into the many technical details of determining taxable income, however.)

Different tax rates on different levels of business taxable income

Personal taxes, which apply to sole traders and partnerships, come on a sliding scale up to a maximum of 40 per cent. When trading as a company a business’s annual taxable income isn’t taxed at a flat rate either. In writing the income tax law, the government gave the little guy a break. As of 2011, the corporate income tax rate starts at 20 per cent on the first £300,000 of taxable income, then quickly moves up to a 26 per cent rate on taxable income in the range of £300,001 to £1,500,000, after which it drops back to 20 per cent. Simple it ain’t! The income tax on the taxable income for the year is calculated using these tax rates.

JARGON ALERT

> In years past, corporate income tax rates were considerably higher, and the rates could go up in the future – although most experts don’t predict any increase. The Chancellor of the Exchequer looks at the income tax law every year and makes some changes virtually every year. Many changes have to do with the accounting methods allowed to determine annual taxable income. For instance, the methods for computing annual *writing down expense*, which recognises the wear and tear on a business’s long-lived operating assets, have been changed back and forth by chancellors over the years. You can check with HM

Revenue and Customs for the latest rules at www.hmrc.gov.uk by simply clicking on ‘Corporation Tax’.

Businesses pay tax on income at different rates depending on their size. But any capital gains (made, for example, when part of a business is sold or when owners cash in) used to be taxed at 10 per cent (if the asset concerned had been owned for two years or more) and then on a sliding scale up to 40 per cent for some assets and some time periods. However, some fiendishly complicated ‘taper reliefs’ existed that made understanding the true tax position very difficult. So, from 2008, all capital gains are now taxed at a single rate of 18 per cent. The simplification does mean that some taxpayers (in particular, any entrepreneurs selling up) face a tax hike of 80 per cent (from 10 per cent up to 18 per cent).

Profit accounting and taxable income accounting

You’re probably thinking that this section of the chapter is about how a business’s bottom-line profit – its net income – drives its taxable income amount. Actually, we want to show you the exact opposite: how income tax law drives a business’s profit accounting. That’s right: Tax law plays a large role in how a business determines its profit figure, or more precisely the accounting methods used to record revenue and expenses.

Before you explore that paradox, you need to understand something about the accounting methods for recording profit. For measuring and recording many expenses (and some types of revenue), no single accounting method emerges as the one and only dominant method. Accountants have a certain amount of legitimate leeway in measuring and reporting the revenue and expenses that drive the profit figure. (See Chapter 13 for further discussion of alternative accounting methods.) Therefore, two different accountants, recording the same profit-making activities for the same period, would most likely come up with two different profit figures – the numbers would be off by at least a little, and perhaps by a lot.

And that inconsistency is fine – as long as the differences are due to legitimate reasons. We'd like to be able to report to you that in measuring profit, accountants always aim right at the bull's-eye, the dead centre of the profit target. One commandment in the accountants' bible is that annual profit should be as close to the truth as can be measured; accounting methods should be objective and fair. But in the real world, profit accounting doesn't quite live up to this ideal.

> Be aware that a business may be tempted to deliberately *overstate* or *understate* its profit. When a business overstates its profit in its profit and loss account, some amount of its sales revenue has been recorded too soon and/or some amount of its expenses has not yet been recorded (but will be later). Overstating profit is a dangerous game to play because it deceives investors and other interested parties into thinking that the business is doing better than it really is. Audits of financial reports by chartered accountants (as discussed in Chapter 15) keep such financial reporting fraud to a minimum but don't necessarily catch every case.

More to the point of this chapter is the fact that most businesses are under some pressure to *understate* the profit reported in their annual income statements. Businesses generally record sales revenue correctly (with some notable exceptions), but they may record some expenses sooner than these costs should be deducted from sales revenue. Why? Businesses are preoccupied with minimising income tax, which means minimising *taxable income.* To minimise taxable income, a business chooses accounting methods that record expenses as soon as possible. Keeping two sets of books (accounting records) – one for tax returns and one for internal profit accounting reports to managers – is not very practical, so the business uses the accounting methods kept for tax purposes for other purposes as well. And that's why tax concerns can drive down a business's profit figure.

In short, the income tax law permits fairly conservative expense accounting methods – expense amounts can be *front-loaded*, or deducted sooner rather than later. The reason is to give a business the option to minimise its current taxable income (even though this course has a reverse effect in later years). Many businesses select these conservative expense methods – both for their income tax returns and for their financial statements reported to managers and to outside investors and lenders. Thus financial statements of many businesses tilt to the conservative, or understated, side.

Of course, a business should report an accurate figure as its net profit, with no deliberate fudging. If you can't trust that figure, who knows for sure exactly how the company is doing? Not the owners, the value of whose investment in the business depends mostly on profit performance, and not even the business's managers, whose business decisions depend on recorded profit performance. Every business needs a reliable profit compass to navigate its way through the competitive environment of the business world – that's just common sense and doesn't even begin to address ethical issues.

Other reasons for understating profit

Minimising taxable income is a strong motive for understating profit, but businesses have other reasons as well. Imagine for the moment that business profit isn't subject to income tax (you wish!). Even in this hypothetical, no-tax world, many businesses probably would select accounting methods that measure their profit on the low side rather than the high side. Two possible reasons are behind this decision:

- **Don't count your chickens before they hatch philosophy:** Many business managers and owners tend to be financially conservative; they prefer to err on the low side of profit measurement rather than on the high side.

- **Save for a rainy day philosophy:** A business may want to keep some profit in reserve so that during a future downturn, it has a profit cushion to soften the blow.

The people who think this way tend to view *overstating profit* as a form of defrauding investors but view *understating profit* as simply being prudent. Frankly, we think that putting your thumb on either side of the profit scale (revenue being one side and expenses the other) is not a good idea. *Let the chips fall where they may* is our philosophy. Adopt the accounting methods that you think best reflect how you operate the business. The income tax law has put too much downward pressure on profit measurement, in our opinion.

We should say that many businesses do report their annual profit correctly – sales revenue and expenses are recorded properly and without any attempt to manipulate either side of the profit equation.

Refer to Chapter 13 for more about how choosing one expense accounting method over another method impacts profit. (***Note:*** The following sections, which discuss expenses and income that are not deductible or are only partially deductible, have nothing to do with choosing accounting methods.)

Deductible expenses

What expenses can you claim when you are self-employed? Expenditure can be split into two main categories, 'Capital' and 'Revenue'.

- **Capital Expenditure:** Capital expenditure is expenditure on such items as the purchase or alteration of business premises, purchase of plant, machinery and vehicles, or the initial cost of tools. You cannot deduct 'capital expenditure' in working out your taxable profits, but some relief may be due on this type of expenditure in the form of capital allowances. Your Tax Office can give further advice on these allowances.
- **Revenue Expenditure:** Listing all the expenses that can be deducted is impossible but, generally speaking,

allowable expenditure relates to day-to-day running costs of your business. It includes such items as wages, rent, lighting and heating of business premises, running costs of vehicles used in the business, purchase of goods for resale and the cost of replacing tools used in the business.

Non-deductible expenses

To be deductible, business expenses must be *ordinary and necessary* – that is, regular, routine stuff that you need to do to run your business. You're probably thinking that you can make an argument that *any* of your expenses meet the ordinary and necessary test. And you're mostly right – almost all business expenses meet this twofold test.

However, HM Revenue and Customs consider certain business expenses to be anything but ordinary and necessary; you can argue about them until you're blue in the face, and it won't make any difference. Examples of non-allowable expenditure are your own wages, premiums on personal insurance policies, and income tax and National Insurance contributions. Where expenditure relates to both business and private use, only the part that relates to the business will be allowed; examples are lighting, heating and telephone expenditure. If a vehicle is used for both business and private purposes, then the capital allowances and the total running expenses will be split in proportion to the business and private mileage. You will need to keep records of your total mileage and the number of miles travelled on business to calculate the correct split.

Here's a list of expenses that are *not* deductible or are only partially deductible when determining annual taxable income:

- **Customer entertainment expenses:** Definitely a no go area. For a while entertaining overseas customers was an allowable tax expense until the Revenue became suspicious of the amazing number of people being entertained by businesses with no export activity whatsoever.
- **Bribes, kickbacks, fines and penalties:** Oh, come on, did you really think that you could get rewarded for doing stuff that's illegal or, at best, undesirable? If you were allowed to deduct these costs, that would be tantamount to the Revenue encouraging such behaviour – a policy that wouldn't sit too well with the general public.
- **Lobbying costs:** You can't deduct payments made to influence legislation. Sorry, but you can't deduct the expenses you ran up to persuade Minister Hardnose to give your bicycle business special tax credits because riding bicycles is good exercise for people.
- **Start-up costs:** You can't just deduct the cost of everything needed to start a business in year one. Some assets, such as cars and equipment or machinery, have to be written down over a number of future years. This area of the tax law can get a little hairy. If you have just started a new business, you may be wise to consult a tax professional on this question, especially if your start-up costs are rather large.
- **Working from home:** If you use part of your home for work, you need to keep sufficient records to back up the proportion of heating and lighting costs that relate to your business and your private use. Sometimes you may not get evidence, such as a receipt, for cash expenses,

especially where the amounts are small. If this happens, make a brief note as soon as you can of the amount you spent, when you spent it, and what it was for. HM Revenue and Customs don't expect you to keep photocopies of bills, although you may find them useful.

- **Life insurance premiums:** A business may buy life insurance coverage on key officers and executives, but if the business is the beneficiary, the premiums are not deductible. The proceeds from a life insurance policy are not taxable income to the business if the insured person dies, because the cost of the premiums was not deductible. In short, premiums are not deductible, and proceeds upon death are excluded from taxable income.
- **Travel and convention attendance expenses:** Some businesses pay for rather lavish conventions for their managers and spend rather freely for special meetings at attractive locations that their customers attend for free. The Revenue takes a dim view of such extravagant expenditures and may not allow a full deduction for these types of expenses. HM Revenue and Customs holds that such conventions and meetings could have been just as effective for a much more reasonable cost. In short, a business may not get a 100 per cent deduction for its travel and convention expenses if the Revenue audits these expenditures.
- **Transactions with related parties:** Income tax law takes a special interest in transactions where the two parties are related in some way. For example, a business may rent space in a building owned by the same people who have money invested in the business; the rent may be artificially high or low in an attempt to shift income and expenses between the two tax entities or individuals. In other words, these transactions may not be based on what's known as *arm's-length bargaining*. A business that

deals with a related party must be ready to show that the price paid or received is consistent with what the price would be for an unrelated party.

You can find a useful guide to business expenses on the www.bytestart.co.uk small business portal. Just click on 'Tax and Accounting' and 'Business Expenses Guide'.

Equity capital disguised as debt

The general term *debt* refers to money borrowed from lenders who require that the money be paid back by a certain date, and who require that interest be paid on the debt until it is repaid. *Equity* is money invested by owners (such as shareholders) in a business in return for hoped-for, but not guaranteed, profit returns. Interest is deductible, but cash dividends paid to shareholders are not – which gives debt capital a big edge over equity capital at tax time.

Not surprisingly, some businesses try to pass off equity capital as debt on their tax returns so that they can deduct the payments to the equity sources as interest expense to determine taxable income. Don't think that HM Revenue and Customs are ignorant of these tactics: Everything that you declare as interest on debt may be examined carefully, and if the Revenue determines that what you're calling debt is really equity capital, it disallows the interest deduction. The business can make payments to its sources of capital that it calls and treats as interest – but this does not mean that HM Revenue and Customs will automatically believe that the payments are in fact interest. The Revenue follows the general principle of substance over form. If the so-called debt has too many characteristics of equity capital, HM Revenue and Customs treat the payments not as interest but rather as dividend distributions from profit to the equity sources of capital.

In summary, debt must really be debt and must have few or none of the characteristics of equity. Drawing a clear-cut line between debt and equity has been a vexing problem for HM Revenue and Customs, and the rules are complex. You'll probably have to consult a tax professional if you have a question about this issue. Be warned that if you attempt to disguise equity capital as debt, your charade may not work – and the Revenue may disallow any 'interest' payments you have made.

Chapter 4

Accounting and Your Personal Finances

In This Chapter

- Boiling down income tax into a simple model
- Making sure that you know how interest works when borrowing
- Accounting for how your money grows when saving and investing
- Understanding how your return on investment is measured
- Planning for your pension

In this chapter, we look at you as an *individual*. We look over your financial shoulder at four different roles in which some accounting tips can help you – as a taxpayer, as a borrower, as an investor and as a retirement planner. Income tax regulations require self-employed individuals and those earning over a certain amount to do some accounting once a year to determine their taxable income and income tax. You may decide to farm out your income tax return preparation to a tax professional. Even so, you should keep in mind the income tax consequences of earning and spending your income.

The Accounting Vice You Can't Escape

All of us have to earn income, right? Therefore, we're all subject to the income tax regulations, whether we like it or not. These regulations are written in the complex and frustrating language of accounting and so they provide employment for a large number of accountants who are hired to prepare the annual tax returns of individuals and businesses. The alternative to using an accountant is to grit your teeth and do your own taxes. Either way, we strongly suggest that you see the forest and not get lost in all the trees. A thumbnail-sized model of how income tax works will help you in making many important financial decisions and is very useful for mapping your overall financial strategy.

The basic income tax model is also useful for testing investment opportunities that seem too good to be true. We have seen too many people get suckered into questionable investments because of alleged income tax advantages. We're sure you've heard the saying, 'There's one born every minute.'

Don't let the extraordinary complexity of income tax stop you from trying to understand how it works. Here's a basic income tax model for an average taxpayer that's very useful, even though just four factors (numbered 1 to 4) affect the amount of the income tax in this example.

Basic Income Tax Accounting Model

(1)	Annual Income	£62,700
(2)	Less Personal Allowances	£7,475
(3)	Less Deduction for a Stakeholder Pension	£3,600
	Equals Taxable Income	£51,625
(4)	Times the Tax Rates (20% on first £35,001 and 40% on excess)	
	Equals Amount of Income Tax	£14,318

Note: Some sources of income are not taxable or are subject to more favourable tax treatment. Some personal expenditure is deductible, and some is not. Persons who are over 65 or blind get . . . Hold on! Once you start getting into technical details, you're on a slippery slope, and there's no turning back. Our purpose here is not to provide a detailed tax guide but to provide a simple, hands-on income model to show the basic income tax effects of your financial decisions. Several good tax guides are available, including *Tolley's Tax Guides*, published by Butterworths. Websites such as the *Daily Mail*'s www.thisismoney.co.uk/tax provide the latest tax tables for every category of taxpayer.

Following is a brief – and we do mean *brief* – explanation of each factor in the basic income tax model:

- **(1) Income:** Money flowing in your direction from working or owning assets is subject to income tax – unless income tax regulations specifically make the inflow not subject to income tax. (An example is interest income on Tax Exempt savings such as ISAs.)
- **(2) Personal Allowances:** Income tax regulations give every individual a so-called *personal allowance*. The term *allowance* means that a certain amount of income is excused from income tax. For 20011/12 (the amount

changes from year to year), the personal allowance was £7,475 or £9,940 for people over 65 but under 74. Over 75 and the figure goes up again to £10,090.

- **(3) Deductions:** The Government allows certain deductions but not others in arriving at taxable income. For example, payments up to a certain level are allowed into pension schemes.

- **Taxable Income:** The first £11,075 of income earned by the example in the basic income tax model shown is *not* subject to income tax – equal to the personal exemption of £7,475 plus deduction of £3,600 for contributions to a stakeholder pension (The amount you can contribute into a pension and get tax relief varies from year to year at rates announced in the budget). Income above this amount is taxable. The taxable income in this example is £51,625 because the £11,075 of income is offset by allowances and deductions. You multiply the taxable income by the tax rates – one rate for the first layer of taxable income and a higher rate for the next layer – to determine the income tax amount.

- **(4) Tax Rates:** UK income tax is based on the *progressive taxation* philosophy – as your income progresses, your tax rate progresses. Taxable income is subdivided into *brackets* or *layers;* each higher one is subject to a higher income tax rate. The lowest rate is 20 per cent; the top rate is 40 per cent on taxable income in excess of £35,001. The brackets and rates can change from year to year, but don't worry – the chancellor keeps you informed in the booklet that comes with your annual income tax forms.

- **Income Tax Amount:** In 2011/12, the tax rate on £51,625 taxable income was 20 per cent on the first £35,001. The rate then doubles to 40 per cent on all further income.

As you can see in the example, the income tax on the £51,625 taxable income is £13,649.80.

In this example, the income tax of £13,649.80 is 26.44 per cent of the £51,625 taxable income and 22.77 per cent of the £62,700 gross income. However, the *marginal tax rate* gets the most attention. The marginal tax rate is the rate that applies to the margin, or highest layer of taxable income. The margin in this example is the taxable income in excess of £35,001. For each additional £1,000 of income over this amount, the person in this example pays £400 of income tax. They are in the 40 per cent marginal income tax bracket.

The marginal tax rate starts at 20 per cent on the first pound of *taxable* income. Remember that you do not have any taxable income until your annual income exceeds the total of your personal exemptions plus the standard deduction. In this example, the first £11,075 of income is not taxable because the total of personal allowances and deduction equals this amount. The remainder is taxed at 40 per cent.

We find that using a *marginal* income tax rate of 33 per cent is generally accurate and computationally convenient. This number may be too high or too low for a specific individual or married couple, but it's reasonably accurate for a broad range of taxpayers. (If you're a multimillionaire, you probably should shift up to a 39.5 per cent marginal tax rate.) In other words, most of the readers of this book can assume that if they receive a £1,000 raise, about 33 per cent of that will be lost to taxes. Or, if you'd like to buy a new pair of trainers that cost £67 at the sports shop, you need £100 of income before taxes to have £67 left over, after taxes, for the shoes.

The Ins and Outs of Figuring Interest and Return on Investment (ROI)

In addition to understanding the basic model of income tax accounting, you should have a good grip on the calculation of periodic interest and how return on investment is measured. Interest rates and return on investment (ROI) rates are tossed around freely as if everyone were intimately familiar with how these important ratios are calculated. In fact, many people do not understand these key accounting calculations. In our experience, most people get sweaty palms when they have to think about how interest is actually calculated and how investment performance is measured. The following sections should reduce your anxiety about these matters, which have a big impact on your personal financial affairs.

Individuals as borrowers

Everyone borrows money – as car loans, as mortgages, as unpaid credit card balances and so on. When you borrow money, you agree to a method of interest accounting, whether you understand the method or not. You should be clear on the following points:

- If you make more than one loan payment per year, divide the annual interest rate by the number of loan payments to determine the interest rate per period, which usually is a month or a quarter. In other words, the quoted annual rate is simply the number to divide into to get the real interest rate per month or per quarter.
- When you make two or more loan payments, each payment goes first to the interest amount; the remainder is deducted from the loan balance, called the *capital.* The amount of the capital repaid each period is referred to as the *amortisation* of the loan. The total amount borrowed has to be amortised, or paid back to the lender, over the life of the loan.
- Shortening the term of a very long-term loan, say from 30 years to 15 years, results in a dramatic decrease in the total interest paid over the life of the loan, but a relatively small increase in the monthly loan payment amount.
- A monthly interest rate should not be multiplied by 12 to determine the *effective annual interest rate*; likewise, a quarterly interest rate should not be multiplied by 4 to determine the effective annual interest rate. Annual effective rates assume the *compounding* of interest during the year. Compounding means paying interest on interest; it is an extremely important building block for understanding financial matters.

A good example to illustrate several of these points is a typical home mortgage loan.

Home mortgage example

The biggest loan in most individuals' financial lives is a home mortgage. Compared with a short-term car loan, a home mortgage loan can run up to 30 years, and the amount borrowed is usually much larger than for a car (unless you buy a Ferrari).

Suppose that you buy a second home and secure a £180,000 mortgage loan for 30 years at a 9 per cent annual interest rate. The loan requires equal monthly payments, so you divide the annual interest rate by 12 to determine the monthly rate, which is 0.75 per cent (or ¾ of 1 per cent) per month. How much will each of your 360 loan payments be? How do you determine this amount? You probably assume that the lender's quoted amount is correct – and you'd be pretty safe in this assumption. But how can you be sure?

Relatively inexpensive hand-held business/financial calculators are available to quickly determine monthly loan payments. These handy tools have special keys for entering each of the variables of a loan. To determine the monthly payment in this example, we pulled out a calculator and punched in the following numbers for each variable:

- **N** = number of periods – 360 months in this example.
- **INT** = interest rate per period – 0.75 per cent per month in this example (these calculators expect that the interest is given in a percentage, so we typed 0.75, not 0.0075).
- **PV** = present value, or amount borrowed today (the present time) – £180,000 in this example.
- **FV** = future value, or capital amount owed after the final monthly loan payment is made – £0 in this example (which means that the loan is fully amortised and paid

off after the last monthly loan payment; otherwise, there would be a *balloon* payment due at the end of the loan).

- **PMT** = payment per period based on the four numbers just entered – \$1,448.32 in this example (which appears as a negative number, meaning that you have to pay this amount per month).

TIP: The big advantage of a business/financial hand-held calculator is that you can enter the known numbers (the first four) and then simply hit the button for the unknown number, which appears instantly. Another big advantage is that you can keep all these numbers in the calculator and make 'what if' changes very, very quickly. For example, what if the annual interest rate was 8.4 per cent? Just re-enter the new interest rate (0.7 per cent per month) and then call up the new monthly payment amount, which is \$1,371.31. The monthly payment difference multiplied by 360 payments is \$27,725 less interest over the life of the loan. So you might decide to shop around for a lower rate.

TIP: The Financial Times Mortgage Calculator (go to www.ft.com/personal-finance/tools and click on Mortgage Calculator) works out your mortgage repayments at any rate of interest, over any time period, and with variable amounts of deposit.

Now, here's a short test to see if you've been paying attention. Suppose the lender did not charge interest – in other words, the interest rate was zero. What would your monthly payments be in the example we just used? The monthly payments would be simply £180,000 divided by 360 months, or only £500 per month. At a 9 per cent annual interest rate, you have to pay £1,448.32 per month. This does not mean that the extra £948.32 more per month, or £11,379.85 per year, is for interest. Interest is accounted for differently, and just how interest is accounted for makes a big difference to you.

Each mortgage payment is divided between interest and capital amortisation (capital repayment). For the first month, the interest amount is £1,350 (£180,000 loan balance × 0.75 per cent monthly interest rate = £1,350). Therefore, the first month's repayment of the capital is only £98.32. Right off, you can see that the loan's capital balance will go down very slowly – and that a 30-year mortgage loan involves a lot of interest. Lenders provide you with a loan repayment (amortisation) schedule. We encourage you to take a look – although trying to follow down a table of 360 rows of monthly payments is tough going.

Figure 4-1 presents the annual amounts of interest cost and capital reduction for this mortgage loan example. (We generated this data from a Microsoft Excel spreadsheet repayment schedule for the loan.) Note that the annual capital amortisation doesn't overcome annual interest cost until the *23rd year*. In other words, you pay mostly interest during the first 22 years! The right column in the figure shows how slowly the loan balance goes down.

TIP

One alternative that you should definitely consider when taking out a home mortgage is a 15-year loan instead of a 30-year loan. For this home mortgage example, the monthly payment on a 15-year loan is $1,825.68, which is an additional $377.36 per month. The total interest over the life of the 15-year loan is about $149,000, compared with $341,000 on the 30-year loan. The 15-year loan saves you about $192,000 in total interest over the life of the mortgage, and you own your home free and clear 15 years sooner. Of course, you have to come up with $377.36 more per month, which may not be possible in the short run. But after a few years of paying the 30-year amount, you can step up the amount you pay each month and pay off your mortgage sooner. Figure 4-1A (A is for *alternative*) shows the annual interest and capital payments for the 15-year mortgage.

Figure 4-1: Annual summary for a 30-year home mortgage repayment schedule.

Year	Payments	Annual Interest Cost	Annual Amortisation, or Reduction of Principal
1	£17,379.85	£16,150.09	£1,229.75
2	£17,379.85	£16,034.73	£1,345.11
3	£17,379.85	£15,908.55	£1,471.30
4	£17,379.85	£15,770.54	£1,609.31
5	£17,379.85	£15,619.57	£1,760.28
6	£17,379.85	£15,454.44	£1,925.40
7	£17,379.85	£15,273.83	£2,106.02
8	£17,379.85	£15,076.27	£2,303.58
9	£17,379.85	£14,860.18	£2,519.67
10	£17,379.85	£14,623.82	£2,756.03
11	£17,379.85	£14,365.28	£3,014.57
12	£17,379.85	£14,082.49	£3,297.36
13	£17,379.85	£13,773.18	£3,606.67
14	£17,379.85	£13,434.85	£3,945.00
15	£17,379.85	£13,064.78	£4,315.07
16	£17,379.85	£12,660.00	£4,719.85
17	£17,379.85	£12,217.24	£5,162.61
18	£17,379.85	£11,732.95	£5,646.89
19	£17,379.85	£11,203.24	£6,176.61
20	£17,379.85	£10,623.83	£6,756.02
21	£17,379.85	£9,990.07	£7,389.78
22	£17,379.85	£9,296.85	£8,083.00
23	£17,379.85	£8,538.61	£8,841.24
24	£17,379.85	£7,709.24	£9,670.61
25	£17,379.85	£6,802.07	£10,577.77
26	£17,379.85	£5,809.81	£11,570.04
27	£17,379.85	£4,724.46	£12,655.39
28	£17,379.85	£3,537.29	£13,842.56
29	£17,379.85	£2,238.77	£15,141.08
30	£17,379.85	£818.43	£16,561.42
Totals	£521,395.46	£341,395.46	£180,000.00

Figure 4-1A: Annual summary for a 15-year home mortgage repayment schedule.

Year	Payments	Annual Interest Cost	Annual Amortisation, or Reduction of Principal	Loan Balance At End of Year
1	£21,908.16	£15,958.55	£5,949.61	£174,050.39
2	£21,908.16	£15,400.44	£6,507.72	£167,542.67
3	£21,908.16	£14,789.97	£7,118.19	£160,424.48
4	£21,908.16	£14,122.23	£7,785.93	£152,638.56
5	£21,908.16	£13,391.86	£8,516.30	£144,122.26
6	£21,908.16	£12,592.97	£9,315.19	£134,807.07
7	£21,908.16	£11,719.14	£10,189.02	£124,618.06
8	£21,908.16	£10,763.34	£11,144.82	£113,473.24
9	£21,908.16	£9,717.88	£12,190.28	£101,282.97
10	£21,908.16	£8,574.35	£13,333.81	£87,949.16
11	£21,908.16	£7,323.55	£14,584.61	£73,364.55
12	£21,908.16	£5,955.41	£15,952.75	£57,411.80
13	£21,908.16	£4,458.93	£17,449.23	£39,962.57
14	£21,908.16	£2,822.07	£19,086.08	£20,876.49
15	£21,908.16	£1,031.67	£20,876.49	£0.00
Totals	£328,622.37	£148,622	£180,000	

You may be tempted to focus on the amount of the monthly payment and how this amount fits into your personal budget. But you should also look closely at the pattern of interest versus capital payments over the life of the loan. In our experience, overlooking interest versus capital payments is the biggest mistake borrowers make. You should always know how fast you're paying off capital, and you should keep track of your loan balance.

Tools of the trade

We advise everyone to invest the time and effort (plus a relatively small cost) in learning how to use one of two indispensable tools of the trade for analysing savings and investments: a hand-held business/financial calculator and a computer spreadsheet program, such as Excel, Quattro Pro or Lotus 1–2–3.

A powerful business/financial hand-held calculator costs under £50. You have to take some time and go through a few examples to learn how to operate the thing, but we think the time is well spent. The owner's manuals for the Hewlett Packard business/financial calculators are very well written and have good practical examples.

If you already use a computer spreadsheet program, take advantage of its financial functions. For example, you can easily print out loan repayment schedules, savings plans, pension fund accumulations, estimated retirement income and many other useful tables and schedules and convert these into charts for easier viewing. The spreadsheet owner's manuals are terrible, we know. We suggest buying the *For Dummies* book for the spreadsheet program you use.

Individuals as savers

Ben Franklin said, 'A penny saved is a penny earned.' His point is that one penny not spent today is a penny kept for another day. Until that later day arrives, the penny saved can earn interest income. These days, 100 pennies saved for one year earn about 6 pennies in interest income, or 6 per cent per year.

Saving is done for income and safety of capital and not for market value appreciation. Suppose you save £10,000 for one year. You expect to earn the going interest rate, *and* you expect to have little or no risk of losing any of your money during the year. You do not expect your savings to appreciate in value other than from interest income. Assuming that the going interest rate is 6 per cent, you expect that your savings will grow to £10,600 by the end of the year – the £10,000 you started with plus 6 per cent interest (or £6 per £100) earned on that money. The interest income increases your taxable income by the same amount, so keep in mind the marginal income tax rate that takes a bite out of your £600 in interest income.

The power of compounding (which means not spending your interest income)

Suppose you have some money that you want to save. You can deposit your money in a savings account at a building society or a bank. Or you can buy a government gilt stock, which is the way governments finance their borrowings. Or you can put your money in a money market fund. You can save money through many different types of vehicles and instruments, which are explained in Eric Tyson's excellent book *Personal Finance For Dummies* (Wiley). Our purpose is to demonstrate how your savings grow, or do not grow, depending on what you do with the interest income each period.

Suppose you have £100,000 in savings. (Larger amounts of money are more interesting than smaller amounts.) You leave the money alone for one year, and at the end of the year your savings balance has grown to £106,000. Therefore, you earned a 6 per cent annual interest income:

> £6,000 increase in savings balance ÷ £100,000 balance at start of year = 6%

Now you have a critical choice to make: Should you withdraw the £6,000 income and spend the money, or should you leave the £6,000 in savings? Many people depend on income from their savings for living expenses. Others want to build up their money over time. Suppose you're in the second group; you leave the first year's interest income in your savings account for a second year.

At the end of the second year your savings amount is £112,360 – £6,360 more than at the start of the year. Therefore, for the second year, you also earned a 6 per cent annual interest rate:

> £6,360 increase in savings balance ÷ £106,000 balance at start of year = 6%

You earned more interest income in the second year because you had more in savings at the start of the year. Notice that at the end of the second year you have two years of interest income accumulated: £6,000 from year one and £6,360 from year two, making a total increase of £12,360 in your savings amount.

If you continue to plough back annual earnings for 12 years, how much would you have at the end of the 12 years – starting with £100,000, earning 6 per cent per year, and resaving interest income every year? Without touching a calculator, we know that your savings balance after 12 years would about double, or would be £200,000. This quick-and-dirty method is based on the *rule of 72* (see the sidebar 'The rule of 72'). To be more precise, your savings balance at the end of 12 years would be £201,220. We did this computation with a calculator. (If you use Microsoft Excel, you might double-check this amount by using the FV financial function; or you can go to a website that has a financial calculator.)

Note: We use the terms *plough back* and *resaving* in order to avoid the term *reinvesting*. Reinvesting implies an investment, which, strictly speaking, involves market value fluctuation risk. Saving does not involve this risk. (We should warn you that there is always a small risk that part of the money in a savings account or fund will be lost or will be delayed in being returned to you – witness the recent Equitable Life situation in which pension funds lost considerable value.)

Figure 4-2 illustrates how your savings balance would grow year by year, assuming a 6 per cent annual interest rate for all 12 years. This growth comes at a price – you can't take out annual earnings. Not withdrawing annual earnings is called *compounding*; the term *compound interest* refers to not withdrawing interest income. Compounding means that you save more and more each year. To emphasise this important point, notice in Figure 4-2 that we include a column for the amount of interest income withdrawn each year (which is zero every year in this example).

Furthermore, the entire interest income each year is subject to individual income tax – unless the money is invested in a tax-efficient pension fund. For instance, in year 4 your interest income is £7,146 (see Figure 4-2). At the higher 40 per cent tax rate you would owe £2,858 income tax on your interest income.

Figure 4-2: Growth in savings balance assuming no withdrawals and full compounding of annual interest income.

Year	Savings Balance at Start of Year	Annual Interest Rate	Interest Income on Savings Balance	Amount of Interest Income Withdrawn	Savings Balance at End of Year
1	£100,000	x 6% =	£6,000	£0	£106,000
2	£106,000	x 6% =	£6,360	£0	£112,360
3	£112,360	x 6% =	£6,742	£0	£119,102
4	£119,102	x 6% =	£7,146	£0	£126,248
5	£126,248	x 6% =	£7,575	£0	£133,823
6	£133,823	x 6% =	£8,029	£0	£141,852
7	£141,852	x 6% =	£8,511	£0	£150,363
8	£150,363	x 6% =	£9,022	£0	£159,385
9	£159,385	x 6% =	£9,563	£0	£168,948
10	£168,948	x 6% =	£10,137	£0	£179,085
11	£179,085	x 6% =	£10,745	£0	£189,830
12	£189,830	x 6% =	£11,390	£0	£201,220

TIP

Unfortunately, compounding of earnings is often touted as a sort of magical way to build wealth over time or to make your money double. Don't be suckered by this claim. You sacrifice 12 years of earnings to make your money grow; you don't get to spend the interest income on your savings for 12 years. We don't call this magic, we call it *frugal*. Compounding is not magical – it's a conservative way to build wealth that requires you to forgo a lot of spending along the way.

The rule of 72

A handy trick of the trade is called the rule of 72. In Figure 4-2, at the end of the 12th year, notice that your savings balance is about £200,000 (rounded off) – exactly twice what you started with. This is a good example of the rule of 72. The rule states that if you take the periodic earnings rate as a whole number and divide it into 72, the answer is the number of periods it takes to double what you started with. Sure enough: $72 \div 6 = 12$. Doubling your money at 6 per cent per year takes 12 years.

The rule of 72 assumes compounding of earnings. It's amazingly accurate over a broad range of earnings rates and number of periods. For example, how long does it take to double your money at an 8 per cent annual earnings rate? It takes nine years ($72 \div 8 = 9$). If you earn 18 per cent per year, you double your money in just four years.

One caution: For very low and very high earnings rates, the rule is not accurate and should not be used.

Individuals as investors

The last two decades have seen a remarkable explosion in the number of individuals who invest in the stock market – either directly by buying and selling stocks and shares or indirectly by putting their money in shares of mutual funds (open-end investment companies that act as intermediaries for individuals). Also during this time span, a sea change has occurred in the arena of retirement pension planning, mainly a fundamental shift away from traditional *defined-benefit* pension plans (which are based on years of service to an employer and salaries during the final years of employment) to *defined-contribution* plans (which are based on how much money has been put into individual retirement investment accounts and the earnings performance of the investments).

National Insurance is the government-sponsored defined-benefit retirement plan. Your monthly retirement benefit depends on how many years you have worked and paid the required amount of National Insurance. In the private sector, a large percentage of retired employees still depend on traditional defined-benefit pension plans. However, the growth of defined-contribution plans has been phenomenal – although we think most individuals don't realise that this type of retirement plan puts much more of a burden on them to understand investment performance accounting.

The twofold nature of return on investment

Putting money into savings, such as a savings account or a government bond, is low risk. In contrast, putting money into an *investment*, such as company shares and bonds or property, means that you are taking on more risk – that you may lose part of the amount of money you invest and that the earnings from your investment may fluctuate from year to year. There's no such thing as a free lunch. If you want the higher earnings, you must take greater risk.

JARGON ALERT

Earnings from *investing* capital are generally not referred to as earnings on investment, but rather as *return on investment* (ROI). ROI consists of two parts: (1) *cash income* (if in fact there is cash income) and (2) *market value appreciation or depreciation*. When you invest, you put your money in stocks and bonds (which are called *securities*), or mutual funds, or property, or whatever. The range of possible investments is diverse, to say the least. We recommend Tony Levene's *Investing For Dummies* (Wiley). He explains the wide range of investments open to individuals, from mutual funds to property and most things in between. Investors should understand how return on investment is accounted for no matter which type of investment they choose.

The return on investment, or ROI, for a period is computed as follows, and is usually expressed as a percentage:

> Return for Period ÷ Amount Invested at Start of Period = Rate of Return on Investment (ROI)

Suppose, for example, that your £100,000 investment at the start of the year provided £2,500 cash flow income during the year, and the market value of your investment asset increased £7,500 during the year. Your total return is £10,000 for the year, and your ROI is 10 per cent for the year: £10,000 return ÷ £100,000 invested = 10 per cent ROI.

Often, people use the term *ROI* when they really mean *rate*, or *percentage*, of ROI. Like some words that have a silent character, ROI is frequently used without rate or percentage. Anytime you see the % symbol, you know that the *rate* of ROI is meant. In any case, the ROI rate is not a totally satisfactory measure. For instance, suppose you tell us that your investments earned 18 per cent ROI last year. We know your wealth, or capital, increased 18 per cent – although we don't know how much of this return you received in cash income and how much was an increase in the market value of your investment, and we don't know whether you spent your cash income or reinvested it.

Individuals, financial institutions and businesses always account for the cash income component of investment return. However, the market value gain or loss during the period may or may not be recorded. Most individuals who invest in property, stocks, bonds and so on, do not record the gain or loss in the market value of their investments during the period. So they do not have a full and complete accounting of ROI for the period.

The investment accounting that most individuals do is governed largely by what’s required for income tax purposes. Unrealised market value gains are not taxed, so most investors do not record market value gains. Nevertheless, they keep an eye on market value ups and downs, in addition to their cash income. For example, property investors generally do not measure and record market value changes each year, although they keep an eye on the prices of comparable properties.

In contrast, financial institutions, including banks, mutual funds, insurance companies and pension funds, are governed by generally accepted accounting principles (GAAP). They invest in marketable securities that are held for sale or trading or that are available for sale. GAAP requires that changes in market value of these investments be recognised. On the other hand, GAAP does not require the recording of market value gains and losses for their investments in fixed-income debt securities (for example, bonds and notes) that are held until maturity.

The main point of this discussion is that you should be very clear about what's included and not included in ROI. As just discussed, many individuals do not capture market value changes during the year in accounting for the return, or earnings on their investments – they account for only the cash income part, which gives an incomplete measure of ROI. On the other hand, when a mutual fund advertises that its annual ROI was 18 per cent last year you can be sure that it *does* include the market value gains in this rate (as well as cash income, of course).

A real-world example of ROI accounting

Suppose you invest £94,757.86 today in a UK Gilt (Government borrowing instrument) that has three years to go until its maturity date. The face, or par, value of this debt security is £100,000, which is its maturity value three years hence and which is also the basis on which interest is computed. This gilt-edged stock pays 6 per cent annual interest, which is paid twice a year. The 6 per cent rate is sometimes called the *coupon rate* because in the good old days (before direct deposit by electronic funds transfer) investors in debt securities had to clip one of the interest coupons attached to the debt certificate as it came due and mail the coupon for payment of the interest.

Every six months, the UK Treasury Department sends you £3,000 (depositing the amount directly in your bank account). Assume that you spend the £3,000 twice-yearly interest income.

So far, so good. But now comes a tough question: What’s your ROI rate on this investment?

By paying £94,757.86, you buy the Gilt at a *discount* from its £100,000 maturity value. The discount provides part of your return on investment in addition to your cash-flow interest income. Most of your ROI consists of cash income every six months. But part consists of *market value appreciation* as the note moves closer to its maturity date. This second component does not provide cash flow until the maturity date is reached. Taking both parts into account, your ROI rate is more than the 6 per cent annual interest rate based on the par value of the note.

Tell you what. Guess that the correct ROI rate is 4 per cent per period (every six months), and see whether this rate is correct. We’ll walk you quickly through the accounting in this example to test out the 4 per cent ROI rate. Figure 4-3 demonstrates that in each period, the return on the investment indeed equals 4 per cent of the amount invested at the start of the period. The investor receives only £3,000 per period of cash income. The increase in the value of the note each period as it moves toward its maturity value provides the remainder of the return each period. The total increase in value over the three years is not received until the maturity date, at which time the investment is cashed out. At this time, the individual has to find another investment to put his or her £100,000 into.

An important note regarding annualised ROI rates

In the investment example in Figure 4-3, the increase in value each period is not received in cash. Therefore, it is ‘automatically’ reinvested, or compounded. Due to this compounding, the amount invested increases period to period – see the left column. As a result, the increase in the value amount is larger from period to period.

Figure 4-3: Investing in a UK Gilt at a discount from its maturity value to illustrate a higher ROI rate than just the periodic interest rate paid on the investment.

Period	Investment at Start of Period	Total Return (ROI = 4.0% on Starting Amount)	Two Components of Return: Cash Income		Two Components of Return: Increase in Value	Investment at End of Period
1	£94,757.86	£3,790.31	£3,000.00	+	£790.31	£95,548.18
2	£95,548.18	£3,821.93	£3,000.00	+	£821.93	£96,370.10
3	£96,370.10	£3,854.80	£3,000.00	+	£854.80	£97,224.91
4	£97,224.91	£3,889.00	£3,000.00	+	£889.00	£98,113.91
5	£98,113.91	£3,924.56	£3,000.00	+	£924.56	£99,038.46
6	£99,038.46	£3,961.54	£3,000.00	+	£961.54	£100,000.00
	Totals =	£23,242.14	£18,000.00		£5,242.14	

Please Note: Only the increase in value is compounded, or reinvested each period. The £3,000 cash income each period is not compounded but is, instead, withdrawn from the investment. The amount invested grows period to period only by the increase in value. The total return each period equals 4.0% of the amount invested at the start of the period.

Seems odd, doesn’t it? A 4 per cent ROI earned each half-year is treated as equivalent to 8.16 per cent ROI earned for the whole year. The purpose is to put all investments on the same footing, as it were – so that annual ROI rates can be compared among different investments. The standard practice in the world of finance is to express ROI rates on the basis of a one-year period – even though the investment may be for a shorter period of time. When a less-than-one-year ROI rate (or interest rate) is converted into an equivalent full-year rate, the shorter-term rate is *annualised.* Usually the word *annualised* is not included; it is assumed that you understand that shorter-term rates have been converted into an equivalent annual rate. Any investment income received during the year is assumed to be compounded (reinvested) for the rest of the year to determine the annualised ROI rate, or we should say just the ROI rate.

Suppose you have held an investment for some time – say, 5, 10 or 20 years. Your ROI rate probably has fluctuated from year to year, high in some years and low in others. Now, suppose we ask how you have done on this investment over the years. You could give us the yearly ROI rates. But the more common practice in the investment world is to calculate the *average* ROI – the equivalent constant, or flat rate that would have resulted in the same ending value of your investment.

Average ROI rates are commonly used to summarise the historical investment performance of a mutual fund. You see this measure in several other places as well – for example, in the reporting of investment performance to individuals by their retirement fund managers. Be very careful about using these ROI rates. Keep in mind that the average ROI rate masks the actual year-by-year volatility in investment performance.

For example, suppose that five years ago you put £100,000 in an investment that paid no cash income any year; all the return was in annual changes in the value of the investment. Figure 4-4 summarises the yearly performance of your investment. Your £100,000 original investment five years ago is now worth £248,832. But the annual returns fluctuated widely; you had some good ROI years and some bad years. (Many investors would not tolerate the annual ROI volatility of this type of investment.) What is the average annual ROI for your investment?

Figure 4-4: Yearly investment performance over five years.

Year	Investment Value at Start of Year	Market Value Change During Year	Investment Value at End of Year	ROI For Year
1	£100,000	£70,000	£170,000	70%
2	£170,000	£70,418	£240,418	41%
3	£240,418	£0	£240,418	0%
4	£240,418	(£24,042)	£216,376	-10%
5	£216,376	£32,456	£248,832	15%

Believe it or not, the average ROI for this investment is 20 per cent. You may ask: How can this be correct? Well, 20 per cent is indeed correct. The average annual ROI rate is the uniform rate that would make the investment grow from the original amount invested (£100,000 in this example) to the final value at the end of the investment (£248,832 in this example). You may not be convinced that the average annual ROI rate is 20 per cent unless you actually walk through what would have happened if your investment had increased 20 per cent in value each year.

Figure 4-5 shows this imaginary year-by-year investment value growth. Note that the investment value at the end of the fifth year is exactly £248,832. Of course, you didn't actually earn 20 per cent ROI each year, as a comparison with the actual investment performance in Figure 4-4 reveals. But advertising that the average annual ROI for this investment is 20 per cent is legal and even accurate. Let the investor beware!

Figure 4-5: Proof that the average annual ROI rate for the five-year investment is 20 per cent.

Year	Investment Value at Start of Year	Imputed 20% ROI For Year	Investment Value at End of Year
1	£100,000	£20,000	£120,000
2	£120,000	£24,000	£144,000
3	£144,000	£28,800	£172,800
4	£172,800	£34,560	£207,360
5	£207,360	£41,472	£248,832

The Move Channel has a sophisticated online ROI calculator that you can find at www.themovechannel.com/calculators/roi.asp. The calculator is designed with property investors in mind, but works equally as well with all types of investment. Just substitute their terms, rent, refurbishment costs and so forth, with your own.

An Accounting Template for Retirement Planning

The main financial concern of most people as they approach retirement is whether they will have enough retirement income in addition to what they will receive from the state pension. How much retirement income do you need? How should you take money out of your retirement account, assuming that you have choices? What are the income tax effects of withdrawals from your tax-deferred retirement funds?

We can't begin to answer these questions here. But we can offer a basic template to get you going and to help you negotiate the first steps in financial retirement planning. Figure 4-6 illustrates how to calculate your *replacement ratio,* which you compute by dividing retirement income by pre-retirement income. The point is that your retirement income replaces your wage, or salary, or other earned income, and that it's very important to calibrate your retirement income as a percentage of your pre-retirement income. Most financial advisers recommend that your replacement ratio should be at least 70 per cent, in order to maintain your standard of living at a reasonably comparable level.

Figure 4-6: Accounting template for figuring retirement income replacement ratio.

Monthly Income and Deductions	Before retirement £	After retirement £
Gross income before deductions	6,000	3,960
National Insurance at 11%	(660)	
Employees pension contribution (at 7%)	(420)	
Additional Personal Tax allowance for the over 65s		28
Take home pay before tax	4,920	3,988
REPLACEMENT RATIO 81%		

For this example, we used numbers based on reasonable assumptions and typical conditions. Prior to retirement, Pat (as we call the person in this example) was earning £6,000 per month. Upon retirement, this regular pay cheque stops coming. Pat has to depend on either the company's pension plan (in a defined-benefit retirement plan) or on the accumulated investment amount (in a defined-contribution plan). Without going into details, assume that Pat's monthly retirement income will be £3,960 per month, which is two thirds of Pat's pre-retirement income. But hold on; you have to consider several other important factors.

In 2011/12, an employee has to pay 12 per cent National Insurance tax on the first £43,875 (approx) of annual earned income. Once retired, Pat doesn't have to pay the tax; instead Pat starts receiving state pension income, which is about £520 per month for a married man (This whole state pension arena is up for grabs right now, so goodness knows what this figure will actually be when you come to retire). Pat also stops making pension contributions. The bottom line is that Pat's take-home monthly income, before income tax, is £3,988 after retirement and £4,920 before retirement – which is a replacement ratio of

81 per cent. Most financial advisers consider this ratio adequate, although it would be better, of course, if Pat's retirement nest egg had been bigger to provide more income during the golden years. The template shown in Figure 4-6 allows you to start with a replacement ratio goal, say 85 per cent, and then work back to how much your retirement income would have to be. Good luck on accumulating enough in your retirement fund to provide the income you need.

To help you work out how much retirement income you might receive from saving into personal, stakeholder or company pensions, use the pension calculator at www.pensioncalculator.org.uk.

Part II

Getting a Grip on Financial Statements

'Look, Mr Brinkley, you don't fool me — you don't have a proper accountant in this company do you?'

In this part . . .

Financial statements are like the tip of an iceberg – they only show the visible part, underneath which are a lot of record-keeping, accounting methods, and reporting decisions. The managers of a business, the investors in a business, and the lenders to a business need a firm grasp on these accounting communications. They need to know which handles to grab hold of and how to find both the good and bad signals in financial statements – and, ugh, this includes the small-print footnotes that go with financial statements.

Accountants prepare three primary financial statements. The profit and loss account reports the profit-making activities of the business and how much profit or loss the business made. (Sounds odd, doesn't it, to say a business made a loss? But to make profit, a business has to take the risk that it may suffer a loss.) The balance sheet reports the financial situation and position of the business at a point in time – usually the last day of the profit period. The cash flow statement reports how much cash was actually realised from profit and other sources of cash, and what the business did with this money. In short, the financial life of a business and its prospects for success or potential danger of failing is all revealed in its financial statements, as this part of the book exposes.

But, as with much in accounting, not everything is quite as it appears. Changing a single letter (FIFO to LIFO) in the footnotes to the accounts can add (or subtract) a small fortune from the reported profit, as you'll see in Chapter 8.

Chapter 5

Profit Mechanics

In This Chapter

- Getting the lowdown on profit
- Analysing the different steps in making profit
- Locating where the profit ends up
- Reporting a profit or loss
- Reporting unusual gains and losses in the profit and loss account

In this chapter we lift up the bonnet and investigate how the profit engine runs. At first glance, making profit may seem fairly simple – sell stuff and control expenses. Bring in more pounds from sales revenue than the pounds paid out for expenses. The excess of revenue over expenses is profit. What's the big deal?

Well, making a profit and determining its amount isn't nearly as simple as you may think. This chapter starts with a simple case in which the increase in cash is equal to profit – the business collects cash for all of its sales during the period and pays out cash for all of its expenses, and profit equals the cash left over. But alas, the business world is not so simple. So the chapter continues one step at a time to build a realistic profit model. Walking through this example lets you answer one very important question: At the end of the day, where exactly is the profit that you worked so hard to earn?

Swooping Profit into One Basic Equation

For a business that sells products, its profit equation is simply sales revenue – expenses = profit, which almost always is reported in a vertical format like this:

Basic Profit Equation

Sales Revenue		£1,000,000
Less Expenses	£940,000	
Equals Profit		£60,000

Profit, in short, equals what's left over from sales revenue after you deduct all expenses. (You never see the term *net sales revenue* instead of *profit.*) This business earned £60,000 on £1,000,000 total sales revenue for the period, which is 6 per cent. Expenses used up 94 per cent of sales revenue. Although it may seem rather thin, a 6 per cent profit margin on sales is typical for many businesses – although some businesses consistently make a bottom-line profit of 10–20 per cent of sales, and others are satisfied with a 1 or 2 per cent profit margin on sales revenue. Normal profit ratios vary widely from industry to industry.

Businesses that sell services instead of products also use the term *sales revenue* for *gross income* (total income before deducting expenses) from sales of their services – but you also see variations on this term. Businesses that don't sell anything as such – financial institutions that earn investment income, for example – use other terms for their gross income.

Notice the following points about the basic profit equation:

- Even though you're deducting expenses from sales revenue, you generally don't use a minus sign or parentheses to indicate that the expense amount is a negative number (although some people do).
- Using a double underline under the profit number is common practice but not universal. Some people use bold type. You generally don't see anything as garish as a fat arrow pointing to the profit number or a big smiley encircling the profit number – but again, tastes vary.

- Profit isn't always called *profit.* It's often called *net income* or the *bottom line* or – particularly on financial reports intended for people outside the business – *net earnings.* (Can't accountants agree on *anything*?) Throughout this book we use the terms *net income* and *profit* pretty much interchangeably.
- *Sales revenue* is the total amount of money or other assets received from sales of the company's products for the entire year. The number used in the profit equation represents all sales – you can't tell how many different sales were made, how many different customers the company sold products to or how the sales were distributed over the 12 months of the year.

  Sales revenue is strictly what belongs to the business and doesn't include money that anyone else can claim (for example, VAT that the business collects from customers and then remits to the government).

Note: A business may have other sources of income in addition to the sales revenue from its products. One common alternative source of income is interest or other return earned on investments the company makes. In the profit report, investment income goes on a separate line and is not included with sales revenue – to make clear that this source of income is secondary to the mainstream sales revenue of the business.

- *Expenses* consist of a wide variety of costs of operating the business and making sales, starting with the cost of the goods (products) sold to the customers and including many other costs of operating the business:

  - Payroll costs (wages, salaries and benefits paid to employees).
  - Insurance costs.
  - Property taxes on buildings and land.
  - Cost of gas and electric utilities.
  - Telephone and Internet charges.
  - Depreciation of operating assets that last more than one year (such as buildings, cars and trucks, computers, office furniture, tools and machinery, and shelving).
  - Website maintenance, advertising and sales promotion costs.
  - Office supplies.
  - Legal and audit costs.
  - Interest paid on loans.

- Income taxes.

As is the case with sales revenue, you can't tell from the amount reported as an expense how much was spent on each component making up the total. For example, the total depreciation expense amount doesn't tell you how much was for buildings and how much was for vehicles.

By the way, notice that only one total is shown for all the business's expenses – to keep the profit equation as short as possible. However, when preparing a formal profit report – which is called a *profit and loss account* – expenses are broken down into several basic categories. (See 'Reporting Profit to Managers and Investors: The Profit and Loss Account' at the end of the chapter.)

Measuring the Financial Effects of Profit-Making Activities

In the basic profit equation example introduced earlier in this chapter, a business earned £60,000 net income for the year. That means it's £60,000 richer now, right? Well, that could happen in a make-believe world, and we start this section with a hypothetical profit example in which the business checking account *does* increase by £60,000 – but this example is extremely oversimplified. In the real world, nothing is that simple.

The financial effects of making profit go far beyond a fatter bank account. To get a clear picture, a balance sheet equation is handy to sort out the various effects. The general format of the balance sheet equation (also called the *accounting equation*) is as follows:

Assets = liabilities + owners' equity

See Chapter 2 for more information about this equation.

Making a profit increases the assets of a business. Assets also increase when the owners invest money in the business and when the business borrows money. These two types of increases in assets are not profit. Profit is the net increase of assets from sales revenue less expenses, not from borrowing and not from its owners investing capital in the business.

Most businesses do not distribute all of their annual profit to their owners; they could, but they don't. Instead, the increase in assets from making profit is used to expand the resource base of the business. Profit not distributed is called reserves or *retained earnings.* The nature of retained earnings is shown in the following rearrangement of the balance sheet equation:

Assets – liabilities – invested capital = retained earnings

The key idea here is that if you start with total assets and then take away how much of the assets came from liabilities and how much was invested by the owners, the remainder must have come from retained earnings. For example, if a business has £6 million in assets, £2 million in liabilities and £3 million in invested capital, the remaining £1 million must be due to retained earnings.

The retained earnings account is *not* – we repeat, *not* – an asset, even though its name may suggest otherwise. It is a *source*-of-assets account, not an asset account. See the 'So why is it called retained earnings?' sidebar for more information about the retained earnings account.

So why is it called retained earnings?

The retained earnings account, like all balance sheet accounts, reports the net balance in the account after recording both the increases *and the decreases* in the account through the end of the period. The retained earnings account increases when the business makes a profit and then decreases when the business distributes some of the profit to the owners. That is, the total amount of profit paid out to the owners is recorded as a decrease in the retained earnings account. (Exactly how the profit is divided among the owners depends on the ownership structure of the business – see Chapter 11.)

The profit-making activities of a business affect several assets and also some liabilities – not the kind recorded when borrowing money (interest-bearing debt), but the kind recorded for expenses that have not been paid immediately. The accounts used to record unpaid expenses are referred to as *operating liabilities.* Interest is paid on debt (borrowed money), but not on operating liabilities. The term *operating* simply refers to the sales and expense operations of a business that are necessary for making profit.

An example: During a period, a business records the full cost of all wages and benefits that its employees earn. The full cost is the correct amount of expense to record in the period to measure profit for the period. But at the end of the period, some part of this total cost has not been paid. The unpaid balance of the total cost is recorded in an operating liability account.

Preparing the balance sheet equation

Each asset of a business is different from the others, but cash is in a class by itself. Furthermore, the cash flow aspects of profit are receiving a great deal of attention these days with survival being as much of a concern as profit itself. So separating assets into cash and non-cash assets is useful. Moreover, separating liabilities into operating liabilities and borrowed money (generally referred to as *debt*) is useful, and separating owners' equity into invested capital and retained earnings is useful. This six-fold subdivision of the balance sheet equation looks like this:

> Cash + non-cash assets = operating liabilities + debt + invested capital + retained earnings

On the one hand, this expansion of the balance sheet equation helps clarify the different types of assets, liabilities and owners' equity. On the other hand, for exploring the profit-making process, debt and invested capital are not needed because revenue and expenses do not involve these two types of accounts. Debt and invested capital are excess baggage for the following journey through the profit-making process of a business. So to simplify the equation assume that the business has no debt and no invested capital (not realistic, but very convenient here). Thus the balance sheet equation that we use in the following sections is as follows:

> Cash + Non-cash Assets = Operating Liabilities + Retained Earnings

A simple, all-cash example to start things off: Suppose your business collected all sales revenue for the year immediately in cash and paid all expenses for the year immediately in cash. Your profit for the year was £60,000. Here's how that profit affects the financial condition of your business (to simplify, pound signs are not used):

Cash	+ Non-cash Assets	=	Operating Liabilities	+	Retained Earnings
	+60,000				+60,000

The cash asset account increases by £60,000, which is the net difference between sales revenue and expenses – your business bank account balance is £60,000 higher at the end of the year than at the beginning of the year. (If you had distributed some of the profit, the balance of the retained earnings account would be the amount you distributed subtracted from £60,000, and your cash would be lower by the same amount.)

Exploring the Profit-Making Process One Step at a Time

We don't mean to scare you off, but the profit picture gets more complex than the simple all-cash example just discussed. Many businesses sell their products on credit rather than cash, for example, and usually don't collect all their sales revenue by the end of the year. In other words some of the expenses for the year aren't paid by the end of the year. Each of the following steps adds a layer of reality, one at a time, to make the profit picture more realistic. The following sections start with the all-cash scenario as the point of departure and then make one change at a time to show you how the additional factor affects the balance sheet equation.

Making sales on credit

If your business allows customers to buy its products or services on credit, you need to add an asset account called *debtors* or *accounts receivable* (also terms we will use interchangeably) that records the total amount owed to the business by its customers who made purchases unofficially and haven't paid up yet. You probably wouldn't have collected all your receivables by the end of the year, especially for credit sales that occurred in the last weeks of the year. However, you still record the sales revenue and the cost-of-goods-sold expense for these sales in the year in which the sales occurred. The initial scenario in which all sales were collected in cash and all expenses were paid in cash is used as the point of reference in the following steps.

Your business had sales revenue of £1 million and total expenses of £940,000, all of which were paid by year-end, making for a bottom-line profit of £60,000. Now assume that £80,000 of the sales revenue came from credit sales that haven't yet been collected at the end of the year. Here's what the financial effects look like (for convenience, pound signs in the balance sheet equation are not used):

Cash +	Non-cash Assets =	Operating Liabilities +	Retained Earnings
	+60,000		+60,000
Accounts receivable			
	–80,000		+80,000

Note that the first line in the balance sheet equation (which is underlined) is from the initial all-cash scenario and serves as the point of reference. Everything in the new scenario is the same as in the all-cash scenario except for the changes shown below the line. Also note that the name of the specific non-cash asset – in this case, accounts receivable – is entered in the balance sheet equation column. When a change in a non-cash asset is entered in the balance sheet equation, the corresponding effect on cash is shown in the cash column.

The £80,000 of uncollected sales revenue at year-end has the effect of decreasing the cash you have by £80,000. Accounts receivable represents cash waiting in the wings to be collected in the near future (assuming that all your customers will pay their accounts receivable to you on time). But until the money is actually received, your business is without the £80,000 cash inflow. This situation may appear to be pretty serious. But hang on; there are several more steps to go.

Whether collected entirely in cash or not, the entire £1 million in sales revenue for the year is recorded and used to calculate profit. So bottom-line profit is £60,000 – the same as in the all-cash scenario. But the cash effects between the two scenarios are quite different. When making sales on credit, you count the sales in calculating your profit, even though the cash is not collected from customers until sometime later. This is one feature of the *accrual basis of accounting*, which is explained in Chapter 3. The accrual basis of accounting records revenue when sales are made and records expenses when these costs are incurred. When sales are made on credit, the accounts receivable asset account is increased; later, when cash is received from the customer, cash is increased and the accounts receivable account is decreased.

Depreciation expense

Depreciation expense accounting is the method of spreading out the cost of a fixed asset instead of charging the entire cost to the year of purchase. That way, each year of use bears a share of the total cost. *Fixed assets* are long-lived operating assets – buildings, machinery, office equipment, vehicles, computers and data-processing equipment, shelving and cabinets, and so on.

For example, cars and light trucks may be depreciated over five years. (Businesses apply the five-year rule to other kinds of assets as well.) The basic idea of depreciation is to charge a fraction of the total cost to depreciation expense for each of the five years. (The actual fraction each year depends on which method of depreciation you choose, which is explained in Chapter 13.)

Suppose your £940,000 total of expenses for the year includes £25,000 depreciation for fixed assets. (You bought these assets for £125,000 and are charging one-fifth of the cost each year for five years.) But you didn't actually pay anything for the fixed assets this year – you bought the assets in previous years. Depreciation is a real expense, but not a *cash outlay* expense after the fixed assets are already bought and paid for. (See the 'Appreciating the positive impact of depreciation on cash flow' sidebar if you're confused about this point.)

Here's what the financial effects of depreciation expense look like:

Cash	+	Non-cash Assets	=	Operating Liabilities	+	Retained Earnings
+60,000						+60,000
+25,000				Fixed assets –25,000		

Appreciating the positive impact of depreciation on cash flow

While making sales on credit does not generate immediate cash inflow and thus has a temporarily negative impact on your cash flow, depreciation is good news for cash flow. This concept gets a little complex, so stay with us here.

Fundamentally, a business sets its sales prices high enough to recover its expenses plus provide a profit. In a real sense, the business is passing on the cost of its fixed assets to its customers and recovering some of the cost of the fixed assets each year through sales revenue. A good example to illustrate this critical point is a taxicab driver who owns his cab. He sets his fares high enough to pay for his time; to pay for the insurance, licence, petrol and oil; and to recover the cost of the cab. Included in each fare is a tiny fraction of the cost of the cab, which over the course of the year adds up to the depreciation expense that he passed on to his passengers and collected in fares. At the end of the year, he has collected a certain amount of money that pays him back for part of the cost of the cab.

In short, fixed assets are gradually *liquidated*, or turned back into cash, each year. Part of sales revenue recovers a fraction of the cost of fixed assets, which is why the decrease in the fixed assets account to record depreciation expense has the effect of increasing cash (assuming your sales revenue was collected in cash during the year). What the company does with this cash recovery is another matter. Sooner or later, you need to replace the fixed assets to continue in business. In this chapter, we do not look beyond the cash recovery of part of the original cost invested in the fixed asset.

Compared with the cash flow effects of accounts receivable, depreciation is good news. Let us put it this way: If all sales revenue had been collected and all expenses except depreciation had been paid during the year, your cash would have increased by £85,000. The company would have realised £60,000 from your profit-making activities plus the £25,000 depreciation recovery during the year. The positive impact of depreciation on cash is just the prelude. Next in line are the favourable cash flow effects of unpaid expenses.

Unpaid expenses

A typical business pays many expenses after the period benefited by the expense. For example, suppose that your business hires a law firm that does a lot of legal work for the company during the year but you don't pay the bill until the following year. Your business may match retirement contributions made by employees but you may not pay your share until the following year. Or your business may have unpaid bills for telephone, gas, electricity and water that it has used during the year.

Accountants use three different types of operating liability accounts to record a business's unpaid expenses:

- **Accounts payable, or creditors:** For items that the business buys on credit and for which it receives an invoice (a bill).

- **Accrued expenses payable:** For unpaid costs that a business generally has to estimate because it doesn't receive an invoice for them. An example of accrued expenses is unused holiday that your employees carry over to the following year, which you will have to pay for in the coming year.
- **Income tax payable:** For income taxes, or corporation tax, that a business still owes to HM Revenue and Customs.

Your business has each of the three operating liabilities we just listed. Some of your total expenses for the year are unpaid at year-end – part in the accounts payable account, part in the accrued expenses payable account and part in the income tax payable account. Here's what the financial effects of your unpaid expenses look like in the balance sheet equation:

Cash	+ Non-cash Assets	= Operating Liabilities	+ Retained Earnings
+60,000		+60,000	
+30,000		Accounts payable +30,000	
+35,000		Accrued expenses payable +35,000	
+5,000		Income tax payable +5,000	

The total of these three unpaid operating liabilities is £70,000 (£30,000 accounts payable + £35,000 accrued expenses payable + £5,000 income tax payable). Your balance sheet would report these liabilities because they are claims against the business. You may think that liabilities are bad, but for cash flow, liabilities are good. Your business has not yet paid £70,000 of the expenses for the year, and your cash balance is higher by this amount – you get to hang on to the cash until you pay the liabilities. Of course, you have to pay these liabilities next year, but isn't it nice to have your balance sheet show a big, fat cash increase for this year even though you have to show the liabilities as well?

Prepaid expenses

Prepaid expenses are the opposite of unpaid expenses. For example, a business buys fire insurance and general liability insurance (in case a customer who slips on a wet floor sues the business). You pay insurance premiums ahead of time, before the period in which you're covered, but you charge that expense to the actual period benefited. At the end of the year, the business may be only halfway through the insurance coverage period, so it charges off only half the premium cost as an expense (for a six-month policy, you charge one-sixth of the premium cost to each of the six months covered). So at the time you pay the premium, you charge the entire amount to the prepaid expenses asset account, and for each month of coverage, you transfer the appropriate fraction of the cost to the insurance expense account.

Here's what the financial effects of your prepaid expenses look like in the balance sheet equation:

Cash	+	Non-cash Assets	=	Operating Liabilities	+	Retained Earnings
+60,000						+60,000
–15,000		Prepaid expenses +15,000				

The build-up of prepaid expenses has a negative impact on the business's cash. In other words you had to write cheques for the prepaid expenses so your cash balance is smaller. The prepayment of these expenses lays the groundwork for continuing your operations seamlessly into next year. What it comes down to is that certain costs of your profit-making operations must be paid in advance – you don't have a choice. Remember that although your business is £15,000 cash poorer, profit remains the same (£60,000) as it was in all the previous scenarios.

Stock (or Inventory) and cost of goods sold expense

JARGON ALERT

Cost of goods sold is one of the primary expenses of businesses that sell products. It's just what its name implies: the cost that a business paid for the products it sells to customers. A business makes profit by setting its sales prices high enough to cover the actual costs of products sold, the costs of operating the business, interest on borrowed money, and income taxes (assuming that the business pays income tax), with something left over for profit.

When the business acquires a product, the cost of the product goes into a *stock asset account* (and, of course, the cost is either deducted from the cash account or added to the accounts payable liability account, depending on whether the business paid with cash or bought on credit). When a customer buys that product, the business transfers the cost of the product from the stock asset account to the cost-of-goods-sold expense account because the product is no longer in the business's stock; the product has been delivered to the customer.

The first step in determining profit for the period is deducting the cost-of-goods-sold expense from the sales revenue for the goods sold. Most profit and loss accounts report the cost of goods sold as a separate expense (refer to 'Reporting Profit to Managers and Investors: The Profit and Loss Account,' later in this chapter).

So assume that your business did, in fact, start the year with a sizable stock of products whose cost is recorded in the stock asset account. As your business sold the products early in the year, the cost of the goods sold was removed from the stock account, and that cost was charged to expense.

Your business sells products so you need to have a stock of products on hand to sell to your customers. This stockpile of goods on the shelves waiting to be sold (or in storage space in the back room) is called *stock.* When you drive by a car dealer and see all the cars waiting to be sold, remember that these products are called stock. The cost of unsold products (goods held in stock) is not charged to expense until the products are actually sold. In this way, the cost-of-goods-sold expense is correctly matched against the sales revenue from the goods sold.

During the year you increased the number of products offered for sale. Therefore, your total purchases of products during the year was £55,000 more than your total cost of goods sold. In other words, you increased the size of your stock by £55,000 cost. The financial effects of your ending stock increase in the balance sheet equation are as follows:

Cash +	Non-cash Assets =	Operating Liabilities +	Retained Earnings
+60,000			+60,000
–55,000	Stock +55,000		

You not only replaced the products sold to customers during the year, but you also bought additional products that cost £55,000. This stock build-up requires cash – notice the £55,000 drain on cash. Your increase in stock may be a smart move but it did use £55,000 in cash.

An increase in the accounts payable liability account may provide part of the stock increase because businesses that have established good credit histories can buy their stock on credit. However, we didn't want to add another change in the accounts payable account and in most situations, a good part of the stock increase would have to be paid for by the end of the year.

So Where's Your Hard-Earned Profit?

As a business manager, not only should you make profit, but you should also understand and manage the financial effects of profit. In particular, understand that profit does not simply mean an increase in cash. Sales revenue and expenses, the two factors of profit, affect many assets and operating liabilities – making sales on credit affects accounts receivable, expenses paid in advance affect prepaid assets, unpaid expenses affect operating liabilities and so on. You simply can't have expenses without a variety of changes in assets and operating liabilities.

Knowing how much profit your business made isn't enough. You need to take another step and ask, 'Did the profit generate an increase in cash equal to the profit?' and, because it hardly ever does, 'Where is the rest of the profit?'

So far, we've looked at each step along the reality road separately, as if it were the only change from the simple cash-basis example. Now we assemble all the steps together that we've analysed since starting with the simple all-cash example. In reading the following summary remember that increases in assets hurt your cash balance but that increases in operating liabilities help your cash balance:

Summary of Changes during Year in Non-cash Assets and Operating Liabilities

Changes in Non-cash Assets:		
Accounts receivable	*+80,000*	
Stock	*+55,000*	
Prepaid expenses	*+15,000*	
Fixed assets	*–25,000*	
Net increase in non-cash assets		*£125,000*

Changes in Operating Liabilities:		
Creditors (accounts payable)	*+30,000*	
Accrued expenses payable	*+35,000*	
Income tax payable	*+5,000*	
Increase of operating liabilities	*£70,000*	
Net decrease in cash balance during year		*£55,000*

Our purpose right now is simply to explain that £55,000 of your profit for the year is not found in an increase in cash but rather consists of the changes in non-cash assets and operating liabilities. Profit is a mixture of changes in the assets and operating liabilities that are an integral part of the profit-making process.

If it isn't in cash, where is it? The following schedule summarises the changes in your non-cash assets and operating liabilities caused by the profit-making steps we showed you earlier in this chapter:

Changes in Non-cash Assets		
Accounts receivable	*+80,000*	
Stock	*+55,000*	
Prepaid expenses	*+15,000*	
Fixed assets	*–25,000*	
Net increase of assets		*+£125,000*
Changes in Operating Liabilities		
Creditors (accounts payable)	*+30,000*	
Accrued expenses payable	*+35,000*	
Income tax payable	*+5,000*	
Less increase of operating liabilities		*–£70,000*
Non-cash components of profit		*+£55,000*

Note: The amounts shown in this summary are the *changes* – the increases and decreases – in the accounts caused by the sales revenue and expense transactions of your business during the year.

And there you have the story of the $60,000 profit – equal to the $5,000 increase of cash plus the $125,000 increase of non-cash assets minus the $70,000 increase in operating liabilities. Probably your biggest surprise here is that, even though your business earned $60,000 in profit for the year, your cash balance increased only $5,000. In managing your profit-making activities (sales revenue and expenses) during the year, you caused cash and three other assets to increase, one asset to decrease and three operating liabilities to increase. Notice that we've put the onus on you, the owner or manager of the business. The point is that these increases and decreases don't happen automatically – they are the result of management decisions.

By the by, you may not like referring to expenses as profit-making activity but they are! The main point is that expenses should generate sales revenue. Advertising expense creates the incentive in customers to buy products sold by the business. Buying products at $60 cost per unit and selling them for $100 per unit generates $40 profit before other expenses are considered – even though the business has $60 of expense (cost of goods sold). Much of business profit-making is built on the model of incurring, say, $90 in expenses to generate, say, $100 in sales revenue.

Other transactions also change the assets, debt and owners' equity accounts of a business – such as borrowing money and buying new fixed assets. The balance sheet, in other words, is changed by all the business's transactions. The profit-making transactions (sales and expenses) are the main transactions changing the balance sheet, but many other transactions are recorded in the asset, liability and owners' equity accounts.

Therefore, a separate summary of the profit-making transactions – limited to sales revenue and expenses – that ends with the profit for the period is a standard part of a complete financial report. This separate profit report is called the *profit and loss account*.

Reporting Profit to Managers and Investors: The Profit and Loss Account

At the end of each period, the accountant prepares a profit report called a *profit and loss account.* You may think that the report would be called the *net profit and loss account* because the bottom-line profit term preferred by accountants is *net income* – but the word *net* is dropped off the title. Other variations of the term are also used, such as *statement of operating results* and *statement of earnings.* Traditionally, the profit and loss account has been called the *profit and loss statement,* or simply the *P&L*, although in external financial reports, businesses and accountants often use the term *income statement*.

The profit and loss account reports the business's sales and expense transactions for the period, with the final profit result on the bottom line. These transactions are *inflows* and *outflows*: Sales revenue is an inflow, and expenses are outflows. Profit, the bottom line, is the *net* inflow. Please note that we didn't say *cash* flow. Making profit involves the inflows and outflows of many assets other than cash, as demonstrated in the steps in the profit-making process examined earlier in the chapter. In the business example earlier in the chapter, the earning of profit involved cash and four other asset accounts as well as three operating liabilities.

The annual profit and loss account included in an external financial report that circulates outside a business has two basic sections (or *layers*):

- The first section presents the usual, ordinary, continuing sales and expense operations of the business for the year.
- The second section presents any unusual, extraordinary, and non- recurring gains and losses that the business recorded in the year.

However, a business that didn't experience any extraordinary gains or losses wouldn't include that second section in its profit and loss account – its profit and loss account would consist simply of the first section.

Reporting normal, ongoing profit-making operations

The top section of a profit and loss account (which is the only section of the profit and loss account if the business doesn't have extraordinary gains or losses to report) typically breaks down total expenses for the year into at least four basic classes. (Refer to the sample profit and loss account at the end of this section for an example.)

- **Cost-of-goods-sold expense:** The cost of the products sold to customers for which the company received the sales revenue reported on the first line of the profit and loss account. The profit line following the deduction of this expense from sales revenue is called *gross margin* (or *gross profit*) – that's your profit before you factor in the other expenses.

Note: Companies that sell services rather than products (airlines, cinemas, accountancy firms and so on) often do not have a cost-of-goods-sold expense line in their profit and loss accounts.

- **Sales, administrative and general expenses:** A broad, catch-all category for all expenses except those reported on the other lines in the profit and loss account. This expense combines such things as legal fees, the boss's salary, advertising costs, travel and entertainment costs, and much more – probably including some of the company's dirty laundry buried deep within.

  The next profit line, which is generally called *earnings before interest and tax* and abbreviated EBIT, is the result after deducting the sales, administrative and general expenses from gross margin.

- **Interest expense:** Interest paid on borrowed money (applies only to businesses that have borrowed money, obviously). This expense is usually reported on a separate line even though it may be relatively small. The profit line after deducting interest expense from earnings before interest and tax is typically called *earnings before income tax* or something similar. (Unfortunately, accounting terminology is not entirely uniform and standardised; you see variations from business to business.)

- **Income tax expense:** Income taxes paid by the business, *not* including property and employer payroll taxes, which are included in the sales, administrative, and general expenses line. Income tax expense is always reported on a separate line. The final profit line, the bottom line after you deduct income tax, is called *net income* – the bottom-line profit figure, unless the business has extraordinary gains and losses to report. If so, the non-recurring gains and losses are included to get down to the bottom line.

To close the business example that we've been using throughout this chapter, here is your annual profit and loss account:

Annual Profit and Loss Account for the Example

Sales revenue	*+1,000,000*
Cost of goods sold expense	*–600,000*
Gross margin	*+400,000*
Sales, administrative and general expenses	*–285,000*
Earnings before interest and tax (EBIT)	*+115,000*
Interest expense	*–25,000*
Earnings before income tax	*+90,000*
Income tax expense	*–30,000*
Net income	*+60,000*

Here are two key points to keep in mind about profit and loss accounts:

- The profit and loss account format that we discuss here is what you find in *external* reports released outside the business that are directed to its absentee owners who do not participate in the day-to-day management of the business. The external profit and loss account does not provide the level of detail about sales revenue and expenses needed for management purposes. Managers must have reports that drill down to the relevant detail they need to make specific decisions and for control purposes. The external profit and loss account is a fairly condensed summary.

- The profit and loss account does not report the financial effects of sales revenue and expenses – the increases and decreases in the assets and operating liabilities that revenue and expenses cause. Readers of the profit report have to look at the balance sheet to see the assets and liabilities of the business. Actually, the cash flow statement that Chapter 7 explains is the link between the profit and loss account and the balance sheet. In short, the profit and loss account is not really a stand-alone financial statement; you have to put it into the financial context of the business's other two primary financial statements: the balance sheet and the cash flow statement.

TIP

The website www.score.org offers a downloadable Excel spreadsheet that enables you to tailor a profit and loss account to your own needs. Scope exists for 7 categories of revenue, 7 cost of sales categories and 20 items of expense. You can find the spreadsheet by going to the SCORE homepage and clicking on 'Templates & Tools' where you will find an extensive selection of templates and calculators.

Reporting unusual gains and losses

The road to profit is anything but smooth and straight. Every business experiences an occasional *discontinuity* – a serious disruption that comes out of the blue, doesn't happen regularly or often, and can dramatically affect bottom-line profit. In other words, a discontinuity is something that disturbs the basic continuity of business operations – the regular flow of profit-making activities.

Here are some examples of discontinuities:

- Downsizing and restructuring the business.
- Abandoning product lines.
- Settling lawsuits and other legal actions.
- Writing down (also called *writing off*) damaged and impaired assets.
- Changing accounting methods.
- Correcting errors from previous financial reports.

With all these extraordinary losses and gains, how can you distinguish the profit that a business earned from its normal revenue and expense activities from profit caused by other forces entirely? This is one case where accounting rules are actually working *for you,* the non-accountant reader of financial reports.

According to financial reporting standards a business must make these one-time losses and gains very visible in the profit and loss account. So in addition to the normal part of the profit and loss account, which reports normal profit activities, a business with unusual, extraordinary losses or gains must add a second layer to the profit and loss account to report on *these* happenings.

If a business has no unusual gains or losses in the year, its profit and loss account ends with one bottom line, usually called *net income* or *profit/loss for the period*. When a profit and loss account includes a second layer, that line becomes *net income from continuing operations before unusual gains and losses.* Below this line, those unusual gains and losses appear for each significant, non-recurring gain or loss.

Say that a business suffered a relatively minor loss from quitting a product line and a very large loss from adopting a new accounting standard. Here's what the second layer of this business's profit and loss account looks like:

Net income from continuing operations	*+267,000,000*
Discontinued operations, net of applicable income taxes	*–20,000,000*
Earnings before cumulative effect of changes in accounting principles	*+247,000,000*
Cumulative effect of changes in accounting principles, net of applicable income taxes	*–456,000,000*
Net earnings (loss)	*–209,000,000*

What new accounting standards could possibly cause a £456 million charge? A very likely scenario could be that this charge is the result of the Accounting Standards Board (ASB) changing the way a business records benefits to retired employees. This business probably hadn't been recording those benefits all along, while the employees were still working (see Chapter 13 for more about recording these kinds of future expenses). For a mature business with many retired employees, the accumulated cost for those benefits could quite conceivably reach that high.

The gains and losses reported in the second layer of the external profit and loss account are generally complex and are not always fully explained in the financial report. So where does that leave you? As we advise in Chapter 14, your best bet is to seek the counsel of expert financial report readers – financial reports are, for all practical purposes, designed for an audience of stockbrokers, sophisticated readers of *The Financial Times* and the like, so don't feel bad that you can't understand a report without a degree in accounting-ese.

Even if you have someone else analyse a two-layer profit and loss account for you, you should be aware of controversial issues that extraordinary losses or gains raise. To really get some respect from your stockbroker or from Joe in Accounting, ask these questions about an unusual loss that a business reports:

- Were the annual profits reported in prior years overstated?
- Why wasn't the loss recorded on a more piecemeal and gradual year-by-year basis instead of as a one-time charge?
- Was the loss really a surprising and sudden event that could not have been anticipated?
- Will such a loss occur again in the future?

Every company that stays in business for more than a couple of years experiences a discontinuity of one sort or another. But beware of a business that takes advantage of discontinuities in either of the following ways:

- **Discontinuities become 'continuities':** This business makes an extraordinary loss or gain a regular feature on its profit and loss account. Every year or so, the business loses a major lawsuit, abandons product lines, or restructures itself. It reports 'non-recurring' gains or losses from the same source on a recurring basis every year.
- **A discontinuity becomes an opportunity to dump all sorts of write-downs and losses:** When recording an unusual loss (such as settling a lawsuit), the business opts to record other losses at the same time – everything but the kitchen sink (and sometimes that, too) gets written off. This *big-bath theory* says that you may as well take a big bath now in order to avoid taking little showers in the future.

Putting the profit and loss account in perspective

The profit and loss account occupies centre stage; the bright spotlight is on this financial statement because it reports profit or loss for the period. But think of the three primary financial statements – the other two being the balance sheet and the cash flow statement – as a three-ring circus. The profit and loss account may draw the most attention but you have to watch what's going on in all three places. As important as profit is to the financial success of a business, the profit and loss account is not an island unto itself. To understand and manage profit, managers have to follow through to the financial effects of revenue and expenses on the assets and liabilities of the business and pay particular attention to cash flow, which Chapter 7 explores.

TIP

The term *financial report,* or *package of accounts,* is the umbrella term referring to a complete set of financial statements. Financial statements are supplemented with footnotes and other commentary from a business's managers. If the financial statements have been audited, the accounting firm includes a short report stating whether the financial statements follow generally accepted accounting principles. Most financial reports, even by small businesses, are bound between two covers. A financial report can be anywhere from 5 pages to more than 50 pages to even 100 pages for very large, publicly owned business corporations. More and more public corporations make their annual financial reports available on their websites, and Yahoo provides direct links to most public companies' reports and accounts online (go to http://uk.finance.yahoo.com and click on 'Free annual reports').

The term *financial statement* refers to one of the following three key summaries prepared periodically by every business:

- **Profit and loss account:** Summarises sales revenue and expenses and ends with the net income (profit) earned for the period or the loss suffered for the period.
- **Balance sheet:** Summarises the balances in the business's assets, liabilities and owners' equity accounts at the close of the period.
- **Cash flow statement:** Summarises the sources and uses of cash during the period.

The annual financial report of a business must include all three of these financial statements. Some businesses also prepare other schedules and summaries of a more limited focus that may also be called a financial statement – but in this book the term *financial statement* refers only to the three primary financial statements that we just listed.

In response to contractual or regulatory requirements some businesses issue special financial reports that do not include a complete set of financial statements with all footnote disclosures, or they may not adopt generally accepted accounting principles for certain matters. The distribution of these special financial reports is limited to specific parties. These special reports should be distinguished from the *general-purpose* financial reports that are distributed to the owners and creditors of the business based on generally accepted accounting principles

Chapter 6

The Balance Sheet from the Profit and Loss Account Viewpoint

In This Chapter

- Coupling the profit and loss account with the balance sheet
- Seeing how sales revenue and expenses drive assets and liabilities
- Sizing up assets and liabilities
- Drawing the line between debt and owners' equity
- Grouping short-term assets and liabilities to determine solvency
- Understanding costs and other balance sheet values

This chapter explores one of the three primary financial statements reported by businesses – the *balance sheet*, or, to be more formal, the *statement of financial condition*. This key financial statement may seem to stand alone – like an island to itself – because it's presented on a separate page in a financial report. In fact, the assets and liabilities reported in a balance sheet are driven mainly by the transactions the business engages in to make profit. These sale and expense transactions of a business are summarised for a period in its *profit and loss account,* which is explained in Chapter 5.

You've probably heard the expression that it takes money to make money. For a business it takes *assets* to make profit. This chapter identifies the particular assets needed to make profit.

Also, the chapter points out the particular liabilities involved in the pursuit of profit.

In brief, a business needs a lot of assets to open its doors and to carry on its profit-making activities – making sales and operating the business from day to day. For example, companies that sell products need to carry a *stock* of products that are available for delivery to customers when sales are made. A business can purchase products for its stock on credit, and delay payment for the purchase (assuming it has a good credit rating). In most cases, however, the business has to pay for these purchases before all the products have been sold – the stock-holding period is considerably longer than the credit period. The business needs cash to pay for its stock purchases. Where does the cash come from?

In fact a business needs many more assets than just stock. Where does the money for these assets come from? Assets are the first act of a two-act play. The second act looks at where the money comes from, or the *sources of capital* for businesses. As Chapter 1 explains, the *balance sheet* of a business is the financial statement that reports its assets on one side and the sources of capital on the other side.

Of course, as we repeat throughout this book, you need to use all three primary financial statements to paint a business's complete financial picture. The *profit and loss account* details sales revenue and expenses, which directly determine the amounts of assets (and two or three of the liabilities) that are summarised in the *balance sheet*. The *cash flow statement* answers the important question of how much of the profit has been converted to cash, and the company's other sources and uses of cash during the period.

This chapter connects sales revenue and expenses, which are reported in the profit and loss account, with their corresponding assets and liabilities in the balance sheet. The chapter also explains the sources of capital that provide the money a business uses to invest in its assets.

Coupling the Profit and Loss Account with the Balance Sheet

Sales revenue generates the inflow of assets and expenses cause the outflow of assets. These increases and decreases in assets have to be recorded. Also, some expenses spawn short-term liabilities that have to be recorded. In short, accounting for profit involves much more than keeping track of cash inflows and outflows. Which specific assets and liabilities are directly involved in recording the sales revenue and expenses of a business? And how are these assets and liabilities reported in a business's balance sheet at the end of the profit period? These are the two main questions that this chapter answers.

This chapter explains how the profit-making transactions reported in the profit and loss account connect with the assets (and some operating liabilities) reported in the balance sheet. We stress the dovetail fit between these two primary financial statements (the profit and loss account and the balance sheet). And don't forget that business accounting also keeps track of where the money for the assets comes from – to invest in its assets, a business needs to raise money by borrowing and persuading owners to put money in the business. You shouldn't look at assets without also looking at where the money (the capital) for the assets comes from.

The *balance sheet*, or statement of financial condition, summarises a business's assets, liabilities and owners' equity at a point in time and, as shown in Chapter 5, can be summarised in the following equation:

Assets	Liabilities	Owners' Equity
Cash + Non-cash Assets =	Operating Liabilities + Debt +	Invested Capital +
Retained Earnings		

Figure 6-1 shows a balance sheet for a fictitious company – not from left to right as shown in the accounting equation just above, but rather from top to bottom, which is a vertical expression of the accounting equation. This balance sheet is stripped down to the bare-bone essentials – please note that it would need a little tidying up before you'd want to show it off to the world in an external financial report (see Chapter 8).

Figure 6-1: A balance sheet example showing a business's various assets, liabilities and owners' equity.

Assets		
Cash		£ 2,000,000
Debtors		£ 2,500,000
Stock		£ 3,575,000
Prepaid Expenses		£ 480,000
Fixed Assets (at Original cost)	£ 11,305,000	
Accumulated Depreciation	£ (5,780,000)	£ 5,525,000
Total		£ 14,080,000
Liabilities and Owners' Equity		
Creditors	£ 800,000	
Accrued Expenses Payable	£ 1,200,000	
Income Tax Payable	£ 80,000	
Total Operating Liabilities		£ 2,080,000
Notes Payable (Interest-bearing debt)		£ 5,000,000
Owners' Invested Capital		£ 2,000,000
Retained Earnings		£ 5,000,000
Total		£ 14,080,000

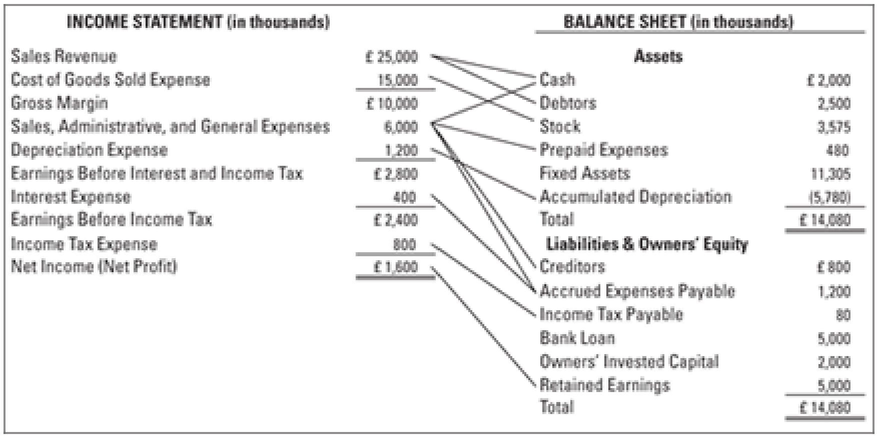
A balance sheet doesn't have a punch line like the profit and loss account does – the profit and loss account's punch line being the net income line (which is rarely humorous to the business itself, but can cause some sniggers among analysts). You can't look at just one item on the balance sheet, murmur an appreciative 'ah-hah,' and rush home to watch the footy game. You have to read the whole thing (sigh) and make comparisons among the items. See Chapters 8 and 14 for more information on interpreting financial statements.

TIP

At the most basic level, the best way to understand a balance sheet (most of it, anyway) is to focus on the assets that are generated by the company's profit-making activities – in other words, the cause-and-effect relationship between an item that's reported in the profit and loss account and an item that's reported in the balance sheet.

Figure 6-2 lays out the vital links between sales revenue and expenses and the assets and liabilities that are driven by these profit-seeking activities. You can refer back to each connection as sales revenue and expenses are discussed below. The format of the profit and loss account is virtually the same as the format introduced in Chapter 5, except that depreciation expense is reported on a separate line (in Chapter 5, depreciation is buried in the sales, administrative and general expenses account).

Figure 6-2: Connections between the assets and operating liabilities of a business and its sales revenue and expenses.



INCOME STATEMENT (in thousands)	
Sales Revenue	£ 25,000
Cost of Goods Sold Expense	15,000
Gross Margin	£ 10,000
Sales, Administrative, and General Expenses	6,000
Depreciation Expense	1,200
Earnings Before Interest and Income Tax	£ 2,800
Interest Expense	400
Earnings Before Income Tax	£ 2,400
Income Tax Expense	800
Net Income (Net Profit)	£ 1,600

BALANCE SHEET (in thousands)	
Assets	
Cash	£ 2,000
Debtors	2,500
Stock	3,575
Prepaid Expenses	480
Fixed Assets	11,305
Accumulated Depreciation	(5,780)
Total	£ 14,080
Liabilities & Owners' Equity	
Creditors	£ 800
Accrued Expenses Payable	1,200
Income Tax Payable	80
Bank Loan	5,000
Owners' Invested Capital	2,000
Retained Earnings	5,000
Total	£ 14,080

REMEMBER

The amounts reported in the profit and loss account are the cumulative totals for the whole year (or other time period). In contrast, the amounts reported in the balance sheet are the *balances* at the end of the year – the net amount, starting with the balance at the start of the year, adjusted for increases and decreases that occur during the year. For example, the total cash inflows and outflows over the course of the entire year were much more than the £2 million ending balance for cash.

The purpose of Figure 6-2 is to highlight the connections between the particular assets and operating liabilities that are tightly interwoven with sales revenue and expenses. Business managers need a good grip on these connections to control assets and liabilities. And outside investors need to understand these connections to interpret the financial statements of a business (see Chapter 14).

Most people intuitively understand that sooner or later sales revenue increases cash and expenses decrease cash. (The exception is depreciation expense, as explained in Chapters 5 and 7.) It's the 'sooner or later' that gives rise to the assets and liabilities involved in making profit.

The assets and liabilities driven by sales revenue and expenses are as follows:

- Sales revenue derives from selling products and services to customers.
- The cost of goods sold expense is what the business paid for the products that it sells to its customers. You can't charge the cost of products to this expense account until you actually sell the goods, so that cost goes into the *stock* asset account until the goods are sold.
- The sales, administrative and general expenses (SA&G) category covers many different operating expenses (such as advertising, travel and telephone costs). SA&G expenses drive the following items on the balance sheet:
  - The *prepaid expenses* asset account holds the total amount of cash payments for future expenses (for example, you pay insurance premiums before the policy goes into effect, so you charge those premiums to the months covered by the policy).
  - The *creditor* liability account is the total amount of expenses that haven't been paid yet but that affect the current period. For example, you receive a bill for electricity that you used the month before, so you charge that bill to the month benefited by the electricity – thanks to the accrual basis of accounting.
  - The *accrued expenses payable* account is the opposite of the prepaid expenses asset account: this liability account holds costs that are paid after

the cost is recorded as an expense. An example is the accumulated holiday pay that the company's employees have earned by the end of the year; when the employees take their holidays next year the company pays this liability.

- The purpose of depreciation is to spread out the original cost of a *fixed asset* over the course of the asset's life. If you buy a vehicle that's going to serve you for five years, you charge one-fifth of the cost to depreciation expense each of the five years. (Instead of charging this straight line, or level amount to each year, a business can choose an accelerated depreciation method, as explained in Chapter 13.) Rather than decreasing the fixed assets account directly (which would make some sense), accountants put depreciation expense in an offset account called *accumulated depreciation*, the balance of which is deducted from the original cost of fixed assets. Thus, both the original cost and the amount by which the original cost has been depreciated to date are available in separate accounts – both items of information are reported in the balance sheet.
- Interest expense depends on the amount of money that the business borrows and the interest rate that the lender charges. *Debt* is the generic term for borrowed money; and debt bears interest. *Loans* and *overdrafts* are the most common terms you see for most debt because the borrower (the business) signs a legal instrument called a *note.* Normally, the total interest expense for a period hasn't been paid by the end of the period so the unpaid part is recorded in *accrued expenses payable* (or in a more specific account of this type called *accrued interest payable*).
- A small part of the total income tax owed on the company's taxable income for the year probably will not

be paid by the end of the year, and the unpaid part is recorded in the *income tax payable* account.

- A final note: The bottom-line profit (net income) for the year increases the reserves or, as it is also known, the *retained earnings* account, which is one of the two owners' equity accounts.

Sizing Up Assets and Liabilities

Although the business example shown in Figure 6–2 is hypothetical, we didn't make up the numbers at random – not at all. We use a medium-sized business that has £25 million in annual sales revenue as the example. (Your business may be a lot smaller or larger than one with £25 million annual sales revenue, of course.) All the other numbers in both the profit and loss account and the balance sheet of the business are realistic relative to each other. We assume the business earns 40 per cent gross margin (£10 million gross margin ÷ £25 million sales revenue = 40 per cent), which means its cost of goods sold expense is 60 per cent of sales revenue. The sizes of particular assets and liabilities compared with their relevant profit and loss account numbers vary from industry to industry, and even from business to business in the same industry.

Based on its history and policies, the managers of a business can estimate what the size of each asset and liability should be – and these estimates provide very useful *control benchmarks*, or yardsticks, against which the actual balances of the assets and liabilities are compared to spot any serious deviations. In other words, assets (and liabilities, too) can be too high or too low in relation to the sales revenue and expenses that drive them, and these deviations can cause problems that managers should try to correct as soon as possible.

Turning over assets

Assets should be *turned over,* or put to use by making sales. The higher the turnover (the more times the assets are used and then replaced), the better. The more sales, the better – because every sale is a profit-making opportunity. The *asset turnover ratio* compares annual sales revenue with total assets:

Annual sales revenue ÷ total assets = asset turnover ratio

The asset turnover ratio is interesting as far as it goes, but it unfortunately doesn't go very far. This ratio looks only at total assets as an aggregate total. And the ratio looks only at sales revenue. The expenses of the business for the year are not considered – even though expenses are responsible for most of the assets of a business.

Note: The asset turnover ratio is a quick-and-dirty test of how well a business is using its assets to generate sales. The ratio does not evaluate profitability; profit is not in the calculation. Basically, the ratio indicates how well assets are being used to generate sales – nothing more.

For example, based on the credit terms extended to customers and the company's actual policies regarding how aggressive the business is in collecting past-due receivables, a manager can determine the range for how much a proper, or within-the-boundaries, balance of accounts receivable should be. This figure would be the control benchmark. If the actual balance is reasonably close to this control benchmark, the debtors' level is under control. If not, the manager should investigate why the debtors' level is higher or lower than it should be.

The following sections discuss the relative sizes of the assets and liabilities in the balance sheet that result from sales and expenses. The sales and expenses are the *drivers*, or causes, of the assets and liabilities. If a business earned profit simply by investing in stocks and bonds, for example, it would not need all the various assets and liabilities explained in this chapter. Such a business – a mutual fund, for example – would have just one income-producing asset: investments in securities. But this chapter focuses on businesses that sell products to make profit.

Sales revenue and debtors

In Figure 6-2 the annual sales revenue is £25 million. Debtors represent one-tenth of this, or £2.5 million. In rough terms, the average customer's credit period is about 36 days – 365 days in the year multiplied by the 10 per cent ratio of ending debtors balance to annual sales revenue. Of course, some customers' balances owed to the business may be past 36 days and some quite new. It's the overall average that you should focus on. The key question is whether or not a customer-credit period averaging 36 days is reasonable or not.

Cost of goods sold expense and stock

In Figure 6-2 the annual cost of goods sold expense is £15 million. The stock is £3,575,000, or about 24 per cent. In rough terms, the average product's stock-holding period is 87 days – 365 days in the year multiplied by the 24 per cent ratio of ending stock to annual cost of goods sold. Of course, some products may remain in stock longer than the 87-day average and some products may sell in a much shorter period than 87 days. It's the overall average that you should focus on. Is an 87-day average stock-holding period reasonable?

The 'correct' average stock-holding period varies from industry to industry. In some industries, the stock-holding period is very long, three months or longer, especially for manufacturers of heavy equipment and high-tech products. The opposite is true for high-volume retailers such as retail supermarkets who depend on getting products off the shelves as quickly as possible. The 87-day average holding period in the example is reasonable for many businesses, but would be far too high for many other businesses.

SA&G expenses and the four balance sheet accounts that are connected with the expenses

Note that in Figure 6-2 sales, administrative and general (SA&G) expenses connect with four balance sheet accounts – cash, prepaid expenses, creditors and accrued expenses payable. The broad SA&G expense category includes many different types of expenses that are involved in making sales and operating the business. (Separate expense accounts are maintained for specific expenses; depending on the size of the business and the needs of its various managers, hundreds or thousands of specific expense accounts are established.)

Cash is paid when recording payroll, mailing and some other expenses. In contrast, insurance and office supplies costs are prepaid, and then released to expense gradually over time. So, cash is paid before the recording of the expense. Some of these expenses are not paid until weeks after being recorded; to recognise the delayed payment the amounts owed are recorded in an accounts payable or an accrued expenses payable liability account.

TIP

One point we would like to repeat is that the company's managers should adopt benchmarks for each of these accounts that are connected with the operating expenses of the business. For example, the £1.2 million ending balance of accrued expenses payable is 20 per cent of the £6 million SA&G for the year. Is this ratio within control limits? Is it too high? Managers should ask and answer questions like these for every asset and liability connected with the expenses of the business.

Fixed assets and depreciation expense

As explained in Chapter 5, depreciation is a truly unique expense. Depreciation is like other expenses in that, like all other expenses, it is deducted from sales revenue to determine profit. Other than this, however, depreciation is very different. None of the depreciation expense recorded to the period requires cash outlay during the period. Rather, depreciation expense for the period is that portion of the total cost of a business's fixed assets that is allocated to the period to record an amount of expense for using the assets during the period. Depreciation is an imputed cost, based on what fraction of the total cost of fixed assets is assigned to the period.

The higher the total cost of its fixed assets, the higher a business's depreciation expense. However, there is no standard ratio of depreciation expense to the total cost of fixed assets. The amount of depreciation expense depends on the useful lives of the company's fixed assets and which depreciation method the business selects. (How to choose depreciation methods is explained in Chapter 13.) The annual depreciation expense of a business is seldom more than 10–15 per cent of the total cost of its fixed assets. The depreciation expense for the year is either reported as a separate expense in the profit and loss account (as in Figure 6–2) or the amount is disclosed in a footnote.

Because depreciation is based on the cost of fixed assets, the balance sheet reports not one but two numbers – the original cost of the fixed assets and the *accumulated depreciation* amount (the amount of depreciation that has been charged as an expense from the time of acquiring the fixed asset to the current balance sheet date).

TIP

The point isn't to confuse you by giving you even more numbers to deal with. Seeing both numbers gives you an idea of how old the fixed assets are and also tells you how much these fixed assets originally cost.

What about cash?

A business's cash account consists of the money it has in its bank accounts plus the money that it keeps on hand to provide change for its customers. Cash is the essential lubricant of business activity. Sooner or later, virtually everything passes through the cash account.

How much of a cash balance should a business maintain? This question has no right answer. A business needs to determine how large a cash safety reserve it's comfortable with to meet unexpected demands on cash while keeping the following wisdom in mind:

- Excess cash balances are non-productive and don't earn any profit for the business.
- Insufficient cash balances can cause the business to miss taking advantage of opportunities that require quick action and large amounts of cash – such as snatching up a prized piece of property that just came on the market and that the business has had its eye on for some time, or buying out a competitor when the business comes up for sale.

The cash balance of the business whose balance sheet is presented in Figure 6–2 is £2,000,000 – which would be too large for some other businesses and too small for others.

In the example, the business has, over several years, invested £11,305,000 in its fixed assets (that it still owns and uses), and it has already charged off depreciation of £4,580,000 in previous years. In this year, the business records £1,200,000 depreciation expense (you can't tell from the balance sheet how much depreciation was charged this year; you have to look at the profit and loss account in Figure 6–2). The remaining non-depreciated cost of this business's fixed assets at the end of the year is £5,525,000. So the fixed assets part of this year's balance sheet looks like this:

Fixed assets	£11,305,000
Accumulated depreciation	(5,780,000)
Net amount included in total assets	£5,525,000

You can tell that the collection of fixed assets includes both old and new assets because the company has recorded £5,780,000 total depreciation since the assets were bought, which is a fairly sizable percentage of original cost (more than half). But many businesses use accelerated depreciation methods, which pile up a lot of the depreciation expense in the early years and less in the back years (see Chapter 13 for more details) so it's hard to estimate the average age of the assets.

Debt and interest expense

REAL WORLD EXAMPLE

The business example whose balance sheet and profit and loss accounts are presented in Figure 6–2 has borrowed £5 million on loans, which, at an 8 per cent annual interest rate, is £400,000 in interest expense for the year. (The business may have had more or less borrowed at certain times during the year, of course, and the actual interest expense depends on the debt levels from month to month.)

For most businesses, a small part of their total annual interest is unpaid at year-end; the unpaid part is recorded to bring the expense up to the correct total amount for the year. In Figure 6–2, the accrued amount of interest is included in the more inclusive accrued expenses payable liability account. You seldom see accrued interest payable reported on a separate line in a balance sheet unless it happens to be a rather large amount or if the business is seriously behind in paying interest on its debt.

Income tax expense

In Figure 6-2, earnings before income tax – after deducting interest and all other expenses from sales revenue – is $2,400,000. (The actual taxable income of the business for the year probably would be somewhat more or less than this amount because of the many complexities in the income tax law, which are beyond the scope of this book.) In the example we use a tax rate of one-third for convenience, so the income tax expense is $800,000 of the pre-tax income of $2,400,000. Most of the income tax for the year must be paid over to HM Revenue and Customs before the end of the year. But a small part is usually still owed at the end of the year. The unpaid part is recorded in the *income tax payable* liability account – as you see in Figure 6–2. In the example, the unpaid part is $80,000 of the total $800,000 income tax for the year – but we don’t mean to suggest that this ratio is typical. Generally, the unpaid income tax at the end of the year is fairly small, but just how small depends on several technical factors. You may want to check with your tax professional to make sure you have paid over enough of the annual income tax by the end of the year to avoid a penalty for late payment.

The bottom line: net profit (net income) and cash dividends (if any)

A business may have other sources of income during the year, such as interest income on investments. In this example, however, the business has only sales revenue, which is gross income from the sale of products and services. All expenses, starting with cost of goods sold, down to and including income tax, are deducted from sales revenue to arrive at the last, or bottom line, of the profit and loss account. The preferred term for bottom-line profit is *net income*, as you see in Figure 6–2.

The £1,600,000 net income for the year increases *retained earnings* by the same amount, hence the line of connection from net income and retained earnings in Figure 6-2. The £1,600,000 profit (here we go again using the term profit instead of net income) either stays in the business, or some of it is paid out and divided among the owners of the business. If the business paid out cash dividends from profit during the year, these cash payments to its owners (shareholders) are deducted from retained earnings. You can't tell from the profit and loss account or the balance sheet whether any cash dividends were paid. You have to look in the cash flow statement for this information – which is explained in Chapter 7.

Financing a Business: Owners' Equity and Debt

You may have noticed in Figure 6-2 that there are two balance sheet accounts that have no lines of connection from the profit and loss account – loans and owners' invested capital. Revenue and expenses do not affect these two key balance sheet accounts (nor the fixed assets account for that matter, which is explained in Chapter 7). However, both debt and owners' invested capital are extremely important for making profit.

To run a business you need financial backing, otherwise known as *capital.* Capital is all incoming funds that are not derived from sales revenue (or from selling off assets). A business raises capital by borrowing money, getting owners to invest money in the business, and making profit that is retained in the business. Borrowed money is known as *debt*; invested money and retained profits are the two sources of *owners' equity*. Those two sources need to be kept separate according to the rules of accounting. See Chapters 5 and 9 for more about profit.

How much capital does the business shown in Figure 6-2 have? Its total assets are £14,080,000, but this is not quite the answer. The company's profit-making activities generated three operating liabilities – creditors, accrued expenses payable and income tax payable – and in total these three liabilities provided £2,080,000 of the total assets of the business. So, deducting this amount from total assets gives the answer: The business has £12 million in capital. Where did this capital come from? Debt provided £5 million and the two sources of owners' equity provided the other £7 million (see Figure 6-1 or 6-2 to check these numbers).

JARGON ALERT

Creditors, accrued expenses payable and income tax payable are short-term, non-interest-bearing liabilities that are sometimes called *current liabilities* because they arise directly from a business's expense activities – they aren't the result of borrowing money but rather are the result of buying things on credit or delaying payment of certain expenses.

This particular business has decided to finance itself through debt and equity in the following mix:

Debt	£5,000,000
Owners' equity	7,000,000
Total sources of capital	£12,000,000

Deciding how to divide your sources of capital can be tricky. In a very real sense, the debt-versus-equity question never has a final answer; it's always under review and reconsideration by most businesses. Some companies, just like some individuals, are strongly anti-debt, but even they may find that they need to take on debt eventually to keep up with changing times.

Debt is both good and bad, and in extreme situations it can get very ugly. The advantages of debt are:

- Most businesses can't raise all the capital they need from owners' equity and debt offers another source of capital (though, of course, many lenders may provide only half or less of the capital that a business needs).
- Interest rates charged by lenders are lower than rates of return expected by owners. Owners expect a higher rate of return because they're taking a greater risk with their money – the business is not required to pay them back the same way that it's required to pay back a lender. For example, a business may pay 8 per cent interest on its debt and have to earn a 13 per cent rate of return on its owners' equity. (See Chapter 14 for more on earning profit for owners.)

The disadvantages of debt are:

- A business must pay the fixed rate of interest for the period even if it suffers a loss for the period.
- A business must be ready to pay back the debt on the specified due date, which can cause some pressure on the business to come up with the money on time. (Of course, a business may be able to *roll over* its debt, meaning that it replaces its old debt with an equivalent amount of new debt, but the lender has the right to demand that the old debt be paid and not rolled over.)

If you default on your debt contract – you don't pay the interest on time, or you don't pay back the debt on the due date – you face some major unpleasantries. In extreme cases, a lender can force you to shut down and liquidate your assets (that is, sell off everything you own for cash) to pay off the debt and unpaid interest. Just as you can lose your home if you don't pay your home mortgage, your business can be forced into involuntary bankruptcy if you don't pay your business debts.

A lender may allow the business to try to work out its financial crisis through bankruptcy procedures, but bankruptcy is a nasty business that invariably causes many problems and can really cripple a business.

Reporting Financial Condition: The Classified Balance Sheet

The assets, liabilities and owners' equity of a business are reported in its *balance sheet,* which is prepared at the end of the profit and loss account period.

The balance sheet is not a flow statement but a *position* statement which reports the financial condition of a company at a precise moment in time – unlike the income and cash flow statements which report inflows and outflows. The balance sheet presents a company's assets, liabilities and owners' equity that exist at the time the report is prepared.

An accountant can prepare a balance sheet at any time that a manager wants to know how things stand financially. However, balance sheets are usually prepared only at the end of each month, quarter and year. A balance sheet is always prepared at the close of business on the last day of the profit period so that the financial effects of sales and expenses (reported in the profit and loss account) also appear in the assets, liabilities and owners' equity sections of the balance sheet.

Trading on the equity: Taking a chance on debt

The large majority of businesses borrow money to provide part of the total capital needed for their assets. The main reason for debt, by and large, is to close the gap between how much capital the owners can come up with and the amount the business needs. Lenders are willing to provide the capital because they have a senior claim on the assets of the business. Debt has to be paid back before the owners can get their money out of the business. The owners' equity provides the permanent base of capital and gives the lenders a cushion of protection.

The owners use their capital invested in the business as the basis to borrow. For example, for every two pounds the owners have in the business, lenders may be willing to add another pound (or even more). Thus, for every two pounds of owners' equity the business can get three pounds total capital to work with. Using owners' equity as the basis for borrowing is called *trading on the equity.* It is also referred to as *financial leverage,* because the equity is the lever for increasing the total capital of the business.

These terms also refer to the potential gain a business can realise from making more EBIT (earnings before interest and tax) on the amount borrowed than the interest on the debt. For a simple example, assume that debt supplies one-third of the total capital of a business (and owners' equity two-thirds, of course), and the business's EBIT for the year just ended is a nice, round £3,000,000. Fair is fair, so you could argue that the lenders who put up one-third of the money should get one-third or £1,000,000 of the profit. This is not how it works. The lenders (investors) get only the interest amount on their loans (their investments). Suppose this total interest is £750,000. The financial leverage gain, therefore, is £250,000. The owners would get their two-thirds share of EBIT plus the £250,000 pre-tax financial leverage gain.

Trading on the equity may backfire. Instead of a gain, the business may realise a financial leverage loss – one-third of its EBIT may be *less* than the interest due on its debt. That interest has to be paid no matter what amount of EBIT the business earns. Suppose the business just breaks even, which means its EBIT equals zero for the year. Nevertheless, it must pay the interest on its debt. So, the business would have a bottom-line loss for the year.

We haven't said much about the situation in which a business has a loss for the year, instead of a profit. A loss has the effect of decreasing the assets of a business (whereas a profit increases its assets). To keep it simple, assume cash is the only asset decreased by the loss (although other assets could also decrease as a result of the loss). Basically, cash goes down by the amount of the loss; and, on the other side of the balance sheet, the retained earnings account goes down the same amount. The owners do not have to invest additional money in the business to cover the loss. The impact on the owners is that their total equity (the recorded value of their ownership in the business) takes a hit equal to the amount of the loss.

The balance sheet shown in Figure 6-1 is a bare-bones statement of financial condition. Yes, the basic assets, liabilities and owners' equity accounts are presented but for both internal management reporting and for external reporting to investors and lenders, the balance sheet must be dressed up rather more than the one shown in Figure 6-1.

TIP

For internal reporting to managers, balance sheets include much more detail either in the body of the financial statement itself or, more likely, in supporting schedules. For example, only one cash account is shown in Figure 6-1 but the chief financial officer of a business needs to see the balances in each of the business's bank accounts.

As another example, the balance sheet shown in Figure 6-1 includes just one total amount for debtors but managers need details on which customers owe money and whether any major amounts are past their due date. Therefore, the assets and liabilities of a business are reported to its managers in greater detail, which allows for better control, analysis and decision-making. Management control is very detail-oriented: Internal balance sheets and their supporting schedules should provide all the detail that managers need to make good business decisions.

JARGON ALERT

In contrast, balance sheets presented in *external* financial reports (which go out to investors and lenders) do not include much more detail than the balance sheet shown in Figure 6-1. However, external balance sheets must classify (or group together) short-term assets and liabilities. For this reason, external balance sheets are referred to as *classified balance sheets.* This classification is not mandatory for internal reporting to managers, although separating short-term assets and liabilities is also useful for managers.

Business balance sheets are not vetted by the accountant to make sure no secrets are being disclosed that would harm national security. The term 'classified' applied to a balance sheet does not mean restricted or top secret; rather, the term means that assets and liabilities are sorted into basic classes, or groups, for external reporting. Classifying certain assets and liabilities into current categories is done mainly to help readers of the balance sheet more easily compare total current assets with total current liabilities for the purpose of judging the short-term solvency of the business.

Solvency refers to the ability of a business to pay its liabilities on time. Delays in paying liabilities on time can cause very serious problems for a business. In extreme cases, a business could be thrown into *bankruptcy* – even the threat of bankruptcy can cause serious disruptions in the normal operations of a business, and profit performance is bound to suffer. If current liabilities become too high relative to current assets – which are the first line of defence for paying those current liabilities – managers should move quickly to raise additional cash to reduce one or more of the current liabilities. Otherwise, a low current ratio will raise alarms in the minds of the outside readers of the business's financial report.

Figure 6-3 presents the *classified* balance sheet for the same company. What's new? Not the assets, liabilities and owners' equity accounts and their balances. These numbers are the same ones shown in Figure 6-1. The classified balance sheet shown in Figure 6-3 includes the following new items of information:

- The first four asset accounts (cash, debtors, stock and prepaid expenses) are added to give the £8,555,000 subtotal for *current assets*.
- The £5,000,000 total debt of the business is divided between £2,000,000 short-term notes payable and £3,000,000 long-term notes payable.
- The first four liability accounts (accounts payable, accrued expenses payable, income tax payable and short-term notes payable) are added to give the £4,080,000 subtotal for *current liabilities*.

Figure 6-3: Example of an external (classified) balance sheet for a business.

Assets		
Cash		£ 2,000,000
Debtors		£ 2,500,000
Stock		£ 3,575,000
Prepaid Expenses		£ 480,000
Current Assets		£ 8,555,000
Fixed Assets (at original cost)	£ 11,305,000	
Accumulated Depreciation	£ (5,780,000)	£ 5,525,000
Total Assets		£ 14,080,000
Liabilities and Owners' Equity		
Creditors		£ 800,000
Accrued Expenses Payable		£ 1,200,000
Income Tax Payable		£ 80,000
Overdraft		£ 2,000,000
Current Liabilities		£ 4,080,000
Loans		£ 3,000,000
Owners' Invested Capital	£ 2,000,000	
Retained Earnings	£ 5,000,000	£ 7,000,000
Total Liabilities and Owners' Equity		£ 14,080,000

Current (short-term) assets

JARGON ALERT

Short-term, or *current*, assets are:

- Cash
- Marketable securities that can be immediately converted into cash
- Operating assets that are converted into cash within one *operating cycle*

Operating cycle refers to the process of putting cash into stock, selling products on credit (which generates debtors) and then collecting the receivables in cash. In other words, the operating cycle is the ‘from cash – through stock and debtors – back to cash’ sequence. The term *operating* refers to those assets that are directly part of making sales and directly involved in the expenses of the company.

Current (short-term) liabilities

Short-term, or *current*, liabilities are those non-interest-bearing liabilities that arise from the operating activities of the business, as well as interest-bearing overdrafts that have a maturity date one year or less from the balance sheet date. Current liabilities also include any other liabilities that must be paid within the upcoming financial period.

Current liabilities are generally paid out of current assets. That is, current assets are the first source of money to pay the current liabilities when those liabilities come due. Thus, total current assets are compared against total current liabilities in order to compute the *current ratio.* For the balance sheet shown in the preceding section, you can compute the current ratio as follows:

£8,555,000 current assets ÷ £4,080,000 current liabilities = 2.1 current ratio

The general rule is that a company’s current ratio should be 1.5 or higher. However, business managers know that the current ratio depends a great deal on how the business’s short-term operating assets are financed from current liabilities. Some businesses do quite well with a current ratio less than 1.5. Therefore, take the 1.5 current ratio rule with a grain of salt. A lower current ratio does not necessarily mean that the business won't be able to pay its short-term (current) liabilities on time. Chapters 14 and 17 explain current ratios in more detail.

Costs and Other Balance Sheet Values

The balance sheet summarises the financial condition for a business at a point in time. Business managers and investors should clearly understand the values reported in this primary financial statement. In our experience, understanding balance sheet values can be a source of confusion for both business managers and investors who tend to put all pound amounts on the same value basis. In their minds, a pound is a pound, whether it's in the debtors, stock, fixed assets, or accounts payable. Assigning the same value to every account value tends to gloss over some important differences and can lead to serious misinterpretation of the balance sheet.

A balance sheet mixes together several different types of accounting values:

- **Cash:** Amounts of money on hand in coin and currency; money on deposit in bank accounts
- **Debtors:** Amounts not yet collected from credit sales to customers

- **Stock:** Amounts of purchase costs or production costs for products that haven't sold yet
- **Fixed assets (or Property, plant, and equipment):** Amounts of costs invested in long-life, tangible, productive operating assets
- **Creditors and accrued liabilities:** Amounts for the costs of unpaid expenses
- **Overdrafts and loans:** Amounts borrowed on interest-bearing liabilities
- **Capital stock:** Amounts of capital invested in the business by owners (shareholders). This can be either by way of the initial capital introduced or profits left in the business after trading gets under way
- **Retained earnings (or reserves):** Amounts remaining in the owners' equity account

In short, a balance sheet represents a diversity, or a rainbow, of values – not just one colour. This is the nature of the generally accepted accounting principles – the accounting methods used to prepare financial statements.

TIP

Book values are the amounts recorded in the accounting process and reported in financial statements. Do not assume that the book values reported in a balance sheet necessarily equal the current *market values.* Book values are based on the accounting methods used by a business. Generally speaking – and we really mean *generally* here because we're sure that you can find exceptions to this rule – cash, debtors, and liabilities are recorded at close to their market or settlement values. These receivables will be turned into cash (at the same amount recorded on the balance sheet) and liabilities will be paid off at the amounts reported in the balance sheet. It's the book values of stock and fixed assets that most likely are lower than current market values, as well as any other non-operating assets in which the business invested some time ago.

A business can use alternative accounting methods to determine the cost of stock and the cost of goods sold, and to determine how much of a fixed asset's cost is allocated to depreciation expense each year. A business is free to use very conservative accounting methods – with the result that its stock cost value and the non-depreciated cost of its fixed assets may be much lower than the current replacement cost values of these assets. Chapter 13 explains more about choosing different accounting methods.

Growing Up

In the layout in Figure 6-4 we start with the fixed assets rather than liquid assets such as cash and work our way down. After the fixed asset sum has been determined to arrive at the residual unwritten down 'value' of those assets, in this case £5,525,000, we work our way down the current assets in the reverse order of their ability to be turned into cash. The total of the current assets comes to £8,555,000.

Next we get the current liabilities, which come to a total of £4,080,000, and subtract that from the current asset total of £8,555,000 to arrive at a figure of £4,475,000. This is often referred to as the *working capital*, as it represents the money circulating through the business day to day.

By adding the net current assets (working capital) of £4,475,000 to the net book value of the fixed assets, £5,525,000, bingo! We can see we have £10,000,000 tied up in net total assets. Deduct the money we owe long term, the creditors due over one year (a fancy way of describing bank and other debt other than overdraft), and we arrive at the net total assets. Net, by the way, is accountant-speak for deduction of one number from another, often adding a four-figure sum to the bill for doing so.

The net total assets figure of £7,000,000 bears an uncanny similarity to the total of the money put in by the owners of the business when they started out, £2,000,000, and the sum they have left in by way of profits undistributed over the years, £5,000,000. So the balance sheet balances, but with a very different total from that of Figure 6-3.

You can find a blank balance sheet and profit and loss accounts in Excel format, as well as a tutored exercise and supporting notes, at www.bized.co.uk/learn/sheets/tasker.xls.

Figure 6-4: A balance sheet.

	£	£	£
Fixed Assets	11,305,000		
Less Accumulated Depreciation	5,780,000		
Net Book Value			5,525,000
Current Assets			
Prepaid Expenses	480,000		
Stock	3,575,000		
Debtors	2,500,000		
Cash	2,000,000		
Total Current Assets		8,555,000	
Less Current Liabilities			
Overdraft	2,000,000		
Income Tax Payable	80,000		
Accrued Expenses	1,200,000		
Creditors	800,000		
Total Current Liabilities		4,080,000	
Net Current Assets			4,475,000
Total Assets			10,000,000
Less Creditors, amounts falling due in over one year			3,000,000
Net Total Assets			7,000,000
Financed By:			
Owners' Capital Introduced		2,000,000	
Reserves (Accumulated Profits)		5,000,000	7,000,000

Chapter 7

Cash Flows and the Cash Flow Statement

In This Chapter

- Separating the three types of cash flows
- Figuring out how much actual cash increase was generated by profit
- Looking at a business's other sources and uses of cash
- Being careful about free cash flow
- Evaluating managers' decisions by scrutinising the cash flow statement

This chapter talks about *cash flows* – which in general refers to cash inflows and outflows over a period of time. Suppose you tell us that last year you had total cash inflows of £145,000 and total cash outflows of £140,000. We know that your cash balance increased £5,000. But we don't know where your £145,000 cash inflows came from. Did you earn this much in salary? Did you receive an inheritance from your rich uncle? Likewise, we don't know what you used your £140,000 cash outflow for. Did you make large payments on your credit cards? Did you lose a lot of money at the races? In short, cash flows have to be sorted into different sources and uses to make much sense.

The Three Types of Cash Flow

Accountants categorise the cash flows of a business into three types:

- Cash inflows from making sales and cash outflows for expenses – sales and expense transactions – are called the *operating activities* of a business (although they could be called profit activities just as well, because their purpose is to make profit).
- Cash outflows for making investments in new assets (buildings, machinery, tools and so on) and cash inflows from liquidating old investments (assets no longer needed that are sold off); these transactions are called *investment activities.*
- Cash inflows from borrowing money and from the additional investment of money in the business by its owners, and cash outflows for paying off debt, returning capital that the business no longer needs to owners and making cash distributions of profit to its owners; these transactions are called *financing activities.*

The cash flow statement (or *statement of cash flows*) summarises the cash flows of a business for a period according to this three-way classification. Generally accepted accounting principles require that whenever a business reports its income statement, it must also report its cash flow statement for the same period – a business shouldn't report one without the other. A good reason exists for this dual financial statement requirement.

KEY CONCEPT

The income statement is based on the *accrual basis of accounting* that records sales when made, whether or not cash is received at that time, and records expenses when incurred, whether or not the expenses are paid at that time. (Chapter 3 explains accrual basis accounting.) Because accrual basis accounting is used to record profit, you can't equate bottom-line profit with an increase in cash. Suppose a business's annual income statement reports that it earned $1.6 million net income for the year. This does not mean that its cash balance increased $1.6 million during the period. You have to look in the cash flow statement to find out how much its cash balance increased (or, possibly, decreased!) from its operating activities (sales revenue and expenses) during the period.

JARGON ALERT

In the chapter, we refer to the net increase (or decrease) in the business's cash balance that results from collecting sales revenue and paying expenses as *cash flow from profit* (the alternative term for *cash flow from operating activities*). Cash flow from profit seems more user-friendly than cash flow from operating activities, and in fact the term is used widely. In any case, do not confuse cash flow from profit with the other two types of cash flow – from the business's investing activities and financing activities during the period.

Before moving on, here's a short problem for you to solve. This summary of the business's net cash flows (in thousands) for the year just ended, which uses the three-way classification of cash flows explained earlier, has one amount missing:

(1) From profit (operating activities)	?
(2) From investing activities	– £1,275
(3) From financing activities	+ £160
Decrease in cash balance during year	– £15

Note that the business's cash balance from all sources and uses decreased £15,000 during the year. The amounts of net cash flows from the company's investing and financing activities are given. So you can determine that the net cash flow from profit was £1,100,000 for the year. Understanding cash flows from investing activities and financing activities is fairly straightforward. Understanding the net cash flow from profit, in contrast, is more challenging – but business managers and investors should have a good grip on this very important number.

Setting the Stage: Changes in Balance Sheet Accounts

The first step in understanding the amounts reported by a business in its cash flow statement is to focus on the *changes* in the business's assets, liabilities and owners' equity accounts during the period – the increases or decreases of each account from the start of the period to the end of the period. These changes are found in the comparative two-year balance sheet reported by a business. Figure 7-1 presents the increases and decreases during the year in the assets, liabilities and owners' equity accounts for a business example. Figure 7-1 is not a balance sheet but only a summary of *changes* in account balances. We do not want to burden you with an entire balance sheet, which has much more detail than is needed here.

Take a moment to scan Figure 7-1. Note that the business's cash balance decreased £15,000 during the year. (An increase is not necessarily a good thing, and a decrease is not necessarily a bad thing; it depends on the overall financial situation of the business.) One purpose of reporting the cash flow statement is to summarise the main reasons for the change in cash – according to the three-way classification of cash flows explained earlier. One question on everyone's mind is this: How much cash did the profit for the year generate for the business? The cash flow statement begins by answering this question.

Figure 7-1: Changes in balance sheet assets and operating liabilities that affect cash flow from profit.

Assets	
Cash	(15)
Debtors	800
Stock	975
Prepaid Expenses	145
Fixed Assets	1,275
Accumulated Depreciation*	(1,200)
Total	1,980
Liabilities & Owners' Equity	
Creditors	80
Accrued Expenses Payable	1,20
Income Tax Payable	20
Overdraft	200
Long-term Loans	300
Owners' Invested Capital	60
Retained Earnings	1,200
Total	1,980

* Accumulated Depreciation is a negative asset account which is deducted from Fixed Assets. The negative £1,200 change increases the negative balance of the account.

Getting at the Cash Increase from Profit

Although all amounts reported on the cash flow statement are important, the one that usually gets the most attention is *cash flow from operating activities*, or *cash flow from profit* as we prefer to call it. This is the increase in cash generated by a business's profit-making operations during the year exclusive of its other sources of cash during the year (such as borrowed money, sold-off fixed assets and additional owners' investments in the business). *Cash flow from profit* indicates a business's ability to turn profit into available cash – cash in the bank that can be used for the needs of business. Cash flow from profit gets just as much attention as net income (the bottom-line profit number in the income statement).

Before presenting the cash flow statement – which is a rather formidable, three-part accounting report – in all its glory, in the following sections we build on the summary of changes in the business's assets, liabilities and owners' equities shown in Figure 7-1 to explain the components of the £1,100,000 increase in cash from the business's profit activities during the year. (The £1,100,000 amount of cash flow from profit was determined earlier in the chapter by solving the unknown factor.)

The business in the example experienced a rather strong growth year. Its accounts receivable and stock increased by relatively large amounts. In fact, all the relevant accounts increased; their ending balances are larger than their beginning balances (which are the amounts carried forward from the end of the preceding year). At this point, we need to provide some additional information. The £1.2 million increase in retained earnings is the net difference of two quite different things.

The £1.6 million net income earned by the business increased retained earnings by this amount. As you see in Figure 7-1, the account increased only £1.2 million. Thus there must have been a £400,000 decrease in retained earnings during the year. The business paid £400,000 cash dividends from profit to its owners (the shareholders) during the year, which is recorded as a decrease in retained earnings. The amount of cash dividends is reported in the *financing activities* section of the cash flow statement. The entire amount of net income is reported in the *operating activities* section of the cash flow statement.

Computation of Cash Flow from Profit (in thousands of pounds)

	Negative Cash Flow Effects	**Positive Cash Flow Effects**
Net income for the year		£1,600
Debtors increase	£800	
Stock increase	£975	
Prepaid expenses increase	£145	
Depreciation expense		£1,200
Creditors increase		£80
Accrued expenses payable increase		£120
Income tax payable increase		£20
Totals	£1,920	£3,020
Cash flow from profit (£3,020 positive increases minus £1,920 negative increases)	£1,100	

Cash flow from profit (£3,020 positive increases minus £1,920 negative increases) £1,100

Note that net income (profit) for the year – which is the correct amount of profit based on the accrual basis of accounting – is listed in the positive cash flow column. This is only the starting point. Think of this the following way: If the business had collected all its sales revenue for the year in cash, and if it had made cash payments for its expenses exactly equal to the amounts recorded for the expenses, then the net income amount would equal the increase in cash. These two conditions are virtually never true, and they are not true in this example. So the net income figure is just the jumping-off point for determining the amount of cash generated by the business's profit activities during the year.

We'll let you in on a little secret here. The analysis of cash flow from profit asks what amount of profit would have been recorded if the business had been on the cash basis of accounting instead of the accrual basis. This can be confusing and exasperating, because it seems that two different profit measures are provided in a business's financial report – the true economic profit number, which is the bottom line in the income statement (usually called *net income*), and a second profit number called *cash flow from operating activities* in the cash flow statement.

When the cash flow statement was made mandatory, many accountants worried about this problem, but the majority opinion was that the amount of cash increase (or decrease) generated from the profit activities of a business is very important to disclose in financial reports. For reading the income statement you have to wear your accrual basis accounting lenses, and for the cash flow statement you have to put on your cash basis lenses. Who says accountants can't see two sides of something?

The following sections explain the effects on cash flow that each balance sheet account change causes (refer to Figure 7-1).

Getting specific about changes in assets and liabilities

TIP

As a business manager, you should keep a close watch on each of your assets and liabilities and understand the cash flow effects of increases (or decreases) caused by these changes. Investors should focus on the business's ability to generate a healthy cash flow from profit, so investors should be equally concerned about these changes.

Debtors increase

Remember that the *debtors* asset shows how much money customers who bought products on credit still owe the business; this asset is a promise of cash that the business will receive. Basically, *debtors* is the amount of uncollected sales revenue at the end of the period. Cash does not increase until the business collects money from its customers.

But the amount in debtors *is* included in the total sales revenue of the period – after all, you did make the sales, even if you haven't been paid yet. Obviously, then, you can't look at sales revenue as being equal to the amount of cash that the business received during the period.

To calculate the actual cash flow from sales, you need to subtract from sales revenue the amount of credit sales that you did not collect in cash over the period – but you add in the amount of cash that you collected during the period just ended for credit sales that you made in the *preceding* period. Take a look at the following equation for the business example, which is first introduced in Chapter 6 – the income statement figures used here are given in Figure 6–2 and the asset and liability changes are shown in Figure 7–1. (No need to look back to Figure 6–2 unless you want to review the income statement.)

> £25 million sales revenue – £0.8 million increase in debtors = £24.2 million cash collected from customers during the year

The business started the year with £1.7 million in debtors and ended the year with £2.5 million in debtors. The beginning balance was collected during the year but at the end of the year the ending balance had not been collected. Thus the *net* effect is a shortfall in cash inflow of £800,000, which is why it's called a negative cash flow factor. The key point is that you need to keep an eye on the increase or decrease in debtors from the beginning of the period to the end of the period.

- If the amount of credit sales you made during the period is greater than the amount collected from customers during the same period, your debtors *increased* over the period. Therefore you need to *subtract* from sales revenue that difference between start-of-period debtors and end-of-period debtors. In short, an increase in debtors hurts cash flow by the amount of the increase.
- If the amount you collected from customers during the period is greater than the credit sales you made during

the period, your debtors *decreased* over the period. In this case you need to *add* to sales revenue that difference between start-of-period debtors and end-of-period debtors. In short, a decrease in debtors helps cash flow by the amount of the decrease.

In the example we've been using, debtors increased £800,000. Cash collections from sales were £800,000 less than sales revenue. Ouch! The business increased its sales substantially over last period, so you shouldn't be surprised that its debtors increased. The higher sales revenue was good for profit but bad for cash flow from profit.

An occasional hiccup in cash flow is the price of growth – managers and investors need to understand this point. Increasing sales without increasing debtors is a happy situation for cash flow, but in the real world you can't have one increase without the other (except in very unusual circumstances).

Stock increase

Stock is the next asset in Figure 7-1 – and usually the largest short-term, or *current,* asset for businesses that sell products. If the stock account is greater at the end of the period than at the start of the period – because either unit costs increased or the quantity of products increased – what the business actually paid out in cash for stock purchases (or manufacturing products) is more than the business recorded as its cost-of-goods-sold expense in the period. Therefore, you need to deduct the stock increase from net income when determining cash flow from profit.

In the example, stock increased £975,000 from start-of-period to end-of-period. In other words, this business replaced the products that it sold during the period *and* increased its stock by £975,000. The easiest way to understand the effect of this increase on cash flow is to pretend that the business paid for all its stock purchases in cash immediately upon receiving them. The stock on hand at the start of the period had already been paid for *last* period, so that cost does not affect this period's cash flow. Those products were sold during the period and involved no further cash payment by the business. But the business did pay cash *this* period for the products that were in stock at the end of the period.

In other words, if the business had bought just enough new stock (at the same cost that it paid out last period) to replace the stock that it sold during the period, the actual cash outlay for its purchases would equal the cost-of-goods-sold expense reported in its income statement. Ending stock would equal the beginning stock; the two stock costs would cancel each other out and thus would have no effect on cash flow. But this hypothetical scenario doesn't fit the example because the company increased its sales substantially over the last period.

To support the higher sales level, the business needed to increase its stock level. So the business bought £975,000 more in products than it sold during the period – and it had to come up with the cash to pay for this stock increase. Basically, the business wrote cheques amounting to £975,000 more than its cost-of-goods-sold expense for the period. This step-up in its stock level was necessary to support the higher sales level, which increased profit – even though cash flow took a hit.

It’s that accrual basis accounting thing again: The cost that a business pays *this* period for *next* period’s stock is reflected in this period’s cash flow but isn’t recorded until next period’s income statement (when the products are actually sold). So if a business paid more *this* period for *next* period’s stock than it paid *last* period for *this* period’s stock, you can see how the additional expense would adversely affect cash flow but would not be reflected in the bottom-line net income figure. This cash flow analysis stuff gets a little complicated, we know, but hang in there. The cash flow statement, presented later in the chapter, makes a lot more sense after you go through this background briefing.

Prepaid expenses increase

The next asset, after stock, is prepaid expenses (refer to Figure 7-1). A change in this account works the same way as a change in stock and debtors, although changes in prepaid expenses are usually much smaller than changes in those other two asset accounts.

Again, the beginning balance of prepaid expenses is recorded as an expense this period but the cash was actually paid out last period, not this period. This period, a business pays cash for next period’s prepaid expenses – which affects this period’s cash flow but doesn’t affect net income until next period. So the £145,000 increase in prepaid expenses from start-of-period to end-of-period in this example has a negative cash flow effect.

As it grows, a business needs to increase its prepaid expenses for such things as fire insurance (premiums have to be paid in advance of the insurance coverage) and its stocks of office and data processing supplies. Increases in debtors, stock and prepaid expenses are the price a business has to pay for growth. Rarely do you find a business that can increase its sales revenue without increasing these assets.

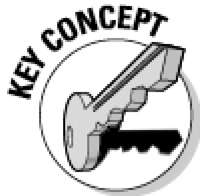
The simple but troublesome depreciation factor

Depreciation expense recorded in the period is both the simplest cash flow effect to understand and, at the same time, one of the most misunderstood elements in calculating cash flow from profit. (Refer to Chapters 5 and 6 for more about depreciation.) To start with, depreciation is not a cash outlay during the period. The amount of depreciation expense recorded in the period is simply a fraction of the original cost of the business's fixed assets that were bought and paid for years ago. (Well, if you want to nit-pick here, some of the fixed assets may have been bought during this period, and their cost is reported in the investing activities section of the cash flow statement.) Because the depreciation expense is not a cash outlay this period, the amount is added back to net income in the calculation of cash flow from profit – so far so good.

When measuring profit on the accrual basis of accounting you count depreciation as an expense. The fixed assets of a business are on an irreversible journey to the junk heap. Fixed assets have a limited life of usefulness to a business (except for land); depreciation is the accounting method that allocates the total cost of fixed assets to each year of their use in helping the business generate sales revenue. Part of the total sales revenue of a business constitutes *recovery of cost invested in its fixed assets*. In a real sense, a business 'sells' some of its fixed assets each period to its customers – it factors the cost of fixed assets into the sales prices that it charges its customers. For example, when you go to a supermarket, a very small slice of the price you pay for that box of cereal goes toward the cost of the building, the shelves, the refrigeration equipment and so on. (No wonder they charge so much for a box of cornflakes!)

Each period, a business recoups part of the cost invested in its fixed assets. In other words, £1.2 million of sales revenue (in the example) went toward reimbursing the business for the use of its fixed assets during the year. The problem regarding depreciation in cash flow analysis is that many people simply add back depreciation for the year to bottom-line profit and then stop, as if this is the proper number for cash flow from profit. It ain't so. The changes in other assets as well as the changes in liabilities also affect cash flow from profit. You should factor in *all* the changes that determine cash flow from profit, as explained in the following section.

Adding net income and depreciation to determine cash flow from profit is mixing apples and oranges. The business did not realise £1,600,000 cash increase from its £1,600,000 net income. The total of the increases of its debtors, stock and prepaid expenses is £1,920,000 (refer to Figure 7-1), which wipes out the net income amount and leaves the business with a cash balance hole of £320,000. This cash deficit is offset by the £220,000 increase in liabilities (explained later), leaving a £100,000 net income *deficit* as far as cash flow is concerned. Depreciation recovery increased cash flow £1.2 million. So the final cash flow from profit equals £1.1 million. But you'd never know this if you simply added depreciation expense to net income for the period.



The managers did not have to go outside the business for the £1.1 million cash increase generated from its profit for the year. Cash flow from profit is an *internal* source of money generated by the business itself, in contrast to *external* money that the business raises from lenders and owners. A business does not have to find sources of external money if its internal cash flow from profit is sufficient to provide for its growth.

Net income + depreciation expense doesn't equal cash flow from profit!

The business in our example earned £1.6 million in net income for the year, plus it received £1.2 million cash flow because of the depreciation expense built into its sales revenue for the year. The sum of these figures is £2.8 million. Is £2.8 million the amount of cash flow from profit for the period? The knee-jerk answer of many investors and managers is 'yes'. But if net income + depreciation truly equals cash flow, then *both* factors in the brackets – both net income and depreciation – must be fully realised in cash. Depreciation is, but the net income amount is not fully realised in cash because the company's debtors, stock and prepaid expenses increased during the year, and these increases have negative impacts on cash flow.

In passing, we should mention that a business could have a negative cash flow from profit for a year – meaning that despite posting a net income for the period, the changes in the company's assets and liabilities caused its cash balance to decrease. In reverse, a business could report a bottom line *loss* in its income statement yet have a *positive* cash flow from its operating activities: The positive contribution from depreciation expense plus decreases in its debtors and stock could amount to more than the amount of loss. More commonly, a loss leads to negative cash flow or very little positive cash flow.

Operating liabilities increases

The business in the example, like almost all businesses, has three basic liabilities that are inextricably intertwined with its expenses: creditors, accrued expenses payable and income tax payable. When the beginning balance of one of these liability accounts is the same as the ending balance of the same account (not too likely, of course), the business breaks even on cash flow for that account. When the end-of-period balance is higher than the start-of-period balance, the business did not pay out as much money as was actually recorded as an expense on the period's income statement.

REAL WORLD EXAMPLE

In the example we've been using, the business disbursed £720,000 to pay off last period's creditors balance. (This £720,000 was reported as the creditors balance on last period's ending balance sheet.) Its cash flow this period decreased by \$720,000 because of these payments. But this period's ending balance sheet shows the amount of creditors that the business will need to pay next period – \$800,000. The business actually paid off \$720,000 and recorded \$800,000 of expenses to the year, so this time cash flow is *richer* than what's reflected in the business's net income figure by \$80,000 – in other words, the increase in creditors has a positive cash flow effect. The increases in accrued expenses payable and income tax payable work the same way.

Therefore, liability increases are favourable to cash flow – in a sense the business borrowed more than it paid off. Such an increase means that the business delayed paying cash for certain things until next year. So you need to add the increases in the three liabilities to net income to determine cash flow from profit, following the same logic as adding back depreciation to net income. The business did not have cash outlays to the extent of increases in these three liabilities.

The analysis of the changes in assets and liabilities of the business that affect cash flow from profit is complete for the business example. The final result is that the company's cash balance increased \$1.1 million from profit. You could argue that cash should have increased \$2.8 million – \$1.6 million net income plus \$1.2 million depreciation that was recovered during the year – so the business is \$1.7 million behind in turning its profit into cash flow (\$2.8 million less the \$1.1 million cash flow from profit). This \$1.7 million lag in converting profit into cash flow is caused by the \$1,920,000 increase in assets less the \$220,000 increase in liabilities, as shown in Figure 7–1.

Presenting the Cash Flow Statement

The cash flow statement is one of the three primary financial statements that a business must report to the outside world, according to generally accepted accounting principles (GAAP). To be technical, the rule says that whenever a business reports a profit and loss account, it should also report a cash flow statement. The *profit and loss account* summarises sales revenue and expenses and ends with the bottom-line profit for the period. The *balance sheet* summarises a business's financial condition by reporting its assets, liabilities and owners' equity. (Refer to Chapters 5 and 6 for more about these reports.)

You can probably guess what the *cash flow statement* does by its name alone: This statement tells you where a business got its cash and what the business did with its cash during the period. We prefer the name given to this statement in the old days in the US – the *Where Got, Where Gone* statement. This nickname goes straight to the purpose of the cash flow statement: asking where the business got its money and what it did with the money.

To give you a rough idea of what a cash flow statement reports, we repeat some of the questions we asked at the start of the chapter: How much money did you earn last year? Did you get all your income in cash (or did some of your wages go straight into a pension plan or did you collect a couple of IOUs)? Where did you get other money (did you take out a loan, win the lottery or receive a gift from a rich uncle)? What did you do with your money (did you buy a house, support your out-of-control Internet addiction or lose it playing bingo)?

KEY CONCEPT

Getting a little too personal for you? That's exactly why the cash flow statement is so important: It bares a business's financial soul to its lenders and owners. Sometimes the cash flow statement reveals questionable judgment calls that the business's managers made. At the very least, the cash flow statement reveals how well a business handles the cash increase from its profit.

JARGON ALERT

As explained at the start of the chapter, the cash flow statement is divided into three sections according to the three-fold classification of cash flows for a business: operating activities (which we also call *cash flow from profit* in the chapter), investing activities and financing activities.

The cash flow statement reports a business's net cash increase or decrease based on these three groupings of the cash flow statement. Figure 7-2 shows what a cash flow statement typically looks like – in this example, for a *growing* business (which means that its assets, liabilities and owners' equity increase during the period).

TECHNICAL STUFF

The history of the cash flow statement

The cash flow statement was not required for external financial reporting until the late 1980s. Until then, the accounting profession had turned a deaf ear to calls from the investment community for cash flow statements in annual financial reports. (Accountants had presented a *funds flow statement* prior to then, but that report proved to be a disaster – the term *funds* included more assets than just cash and represented a net amount after deducting short-term liabilities from short-term, or current, assets.)

In our opinion, the reluctance to require cash flow statements came from fears that the *cash flow from profit* figure would usurp net income – people would lose confidence in the net income line.

Those fears have some justification – considering the attention given to cash flow from profit and what is called 'free cash flow' (discussed later in the chapter). Although the profit and loss account continues to get most of the fanfare (because it shows the magic bottom-line number of net income), cash flow gets a lot of emphasis these days.

Figure 7-2: Cash flow statement for the business in the example.

Cash Flow Statement for Year (in thousands of pounds)		
Cash Flows from Operating Activities		
Net Income		£ 1,600
Debtors	£ (800)	
Stock Increase	£ (975)	
Prepaid Expenses Increase	£ (145)	
Depreciation Expense	£ 1,200	
Creditors Increase	£ 80	
Accrued Expense Increase	£ 120	
Income Tax Payable Increase	£ 20	£ (500)
Cash Flow from Operating Activities		£ 1,100
Cash Flows from Investing Activities		
Purchases of Property, Plant & Equipment		£ (1,275)
Cash Flows from Financing Activities		
Short-term Debt Borrowing Increase	£ 200	
Long-term Debt Borrowing Increase	£ 300	
Share Issue	£ 60	
Dividends Paid Stockholders	£ (400)	£ 160
Increase (Decrease) In Cash During Year		£ (15)
Beginning Cash Balance		£ 2,015
Ending Cash Balance		£ 2,000

The trick to understanding cash flow from profit is to link the sales revenue and expenses of the business with the changes in the business's assets and liabilities that are directly connected with its profit-making activities. Using this approach earlier in the chapter, we determine that the cash flow from profit is £1.1 million for the year for the sample business. This is the number you see in Figure 7-2 for cash flow from operating activities. In our experience, many business managers, lenders and investors don't fully understand these links, but the savvy ones know to keep a close eye on the relevant balance sheet changes.

What do the figures in the first section of the cash flow statement (See Figure 7-2) reveal about this business over the past period? Recall that the business experienced rapid sales growth over the last period. However, the downside of sales growth is that operating assets and liabilities also grow – the business needs more stock at the higher sales level and also has higher debtors.

The business's prepaid expenses and liabilities also increased, although not nearly as much as debtors and stock. The rapid growth of the business yielded higher profit but also caused quite a surge in its operating assets and liabilities – the result being that cash flow from profit is only £1.1 million compared with £1.6 million in net income – a £500,000 shortfall. Still, the business had £1.1 million at its disposal after allowing for the increases in assets and liabilities. What did the business do with this £1.1 million of available cash? You have to look to the remainder of the cash flow statement to answer this key question.

A very quick read through the rest of the cash flow statement (refer to Figure 7-2) goes something like this: The company used £1,275,000 to buy new fixed assets, borrowed £500,000 and distributed £400,000 of the profit to its owners. The result is that cash decreased £15,000 during the year. Shouldn't the business have increased its cash balance, given its fairly rapid growth during the period? That's a good question! Higher levels of sales generally require higher levels of operating cash balances. However, you can see in its balance sheet at the end of the year (refer back to Figure 6-2) that the company has £2 million in cash, which, compared with its £25 million annual sales revenue, is probably enough.

A better alternative for reporting cash flow from profit?

We call your attention, again, to the first section of the cash flow statement in Figure 7-2. You start with net income for the period. Next, changes in assets and liabilities are deducted or added to net income to arrive at cash flow from operating activities (the cash flow from profit) for the year. This format is called the *indirect method.* The alternative format for this section of the cash flow statement is called the *direct method* and is presented like this (using the same business example, with pound amounts in millions):

Cash inflow from sales	£24.2
Less cash outflow for expenses	£23.1
Cash flow from operating activities	£1.1

You may remember from the earlier discussion that sales revenue for the year is £25 million, but that the company's debtors increased £800,000 during the year, so cash flow from sales is £24.2 million. Likewise, the expenses for the year can be put on a cash flow basis. But we 'cheated' here – we have already determined that cash flow from profit is £1.1 million for the year, so we plugged the figure for cash outflow for expenses. We would take more time to explain the direct approach, except for one major reason.

Where to put depreciation?

Where the depreciation line goes within the first section (operating activities) of the cash flow statement is a matter of personal preference – no standard location is required. Many businesses report it in the middle or toward the bottom of the changes in assets and liabilities – perhaps to avoid giving people the idea that cash flow from profit simply requires adding back depreciation to net income.

Although the Accounting Standards Board (ASB) expresses a definite preference for the direct method, this august rule-making body does permit the indirect method to be used in external financial reports – and, in fact, the overwhelming majority of businesses use the indirect method. Unless you're an accountant, we don't think you need to know much more about the direct method.

Sailing through the Rest of the Cash Flow Statement

After you get past the first section, the rest of the cash flow statement is a breeze. The last two sections of the statement explain what the business did with its cash and where cash that didn't come from profit came from.

Investing activities

The second section of the cash flow statement reports the investment actions that a business's managers took during the year. Investments are like tea leaves, serving as indicators regarding what the future may hold for the company. Major new investments are the sure signs of expanding or modernising the production and distribution facilities and capacity of the business. Major disposals of long-term assets and the shedding of a major part of the business could be good news or bad news for the business, depending on many factors. Different investors may interpret this information differently, but all would agree that the information in this section of the cash flow statement is very important.

JARGON ALERT

Certain long-lived operating assets are required for doing business – for example, Federal Express wouldn't be terribly successful if it didn't have aeroplanes and vans for delivering packages and computers for tracking deliveries. When those assets wear out, the business needs to replace them. Also, to remain competitive, a business may need to upgrade its equipment to take advantage of the latest technology or provide for growth. These investments in long-lived, tangible, productive assets, which we call *fixed assets* in this book, are critical to the future of the business and are called *capital expenditures* to stress that capital is being invested for the long term.

One of the first claims on cash flow from profit is capital expenditure. Notice in Figure 7–2 that the business spent $1,275,000 for new fixed assets, which are referred to as *property, plant and equipment* in the cash flow statement (to keep the terminology consistent with account titles used in the balance sheet, because the term *fixed assets* is rather informal).

Cash flow statements generally don't go into much detail regarding exactly what specific types of fixed assets a business purchased – how many additional square feet of space the business acquired, how many new drill presses it bought and so on. (Some businesses do leave a clearer trail of their investments, though. For example, airlines describe how many new aircraft of each kind were purchased to replace old equipment or expand their fleets.)

Note: Typically, every year a business disposes of some of its fixed assets that have reached the end of their useful lives and will no longer be used. These fixed assets are sent to the junkyard, traded in on new fixed assets, or sold for relatively small amounts of money. The value of a fixed asset at the end of its useful life is called its *salvage value.* The disposal proceeds from selling fixed assets are reported as a source of cash in the investments section of the cash flow statement. Usually, these amounts are fairly small. In contrast, a business may sell off fixed assets because it's downsizing or abandoning a major segment of its business. These cash proceeds can be fairly large.

Financing activities

Note that in the annual cash flow statement (refer to Figure 7-2) of the business example we've been using, the positive cash flow from profit is £1,100,000 and the negative cash flow from investing activities is £1,275,000. The result to this point, therefore, is a net cash outflow of £175,000 – which would have decreased the company's cash balance this much if the business did not go to outside sources of capital for additional money during the year. In fact, the business increased its short-term and long-term debt during the year, and its owners invested additional money in the business. The third section of the cash flow statement summarises these financing activities of the business over the period.

The term *financing* generally refers to a business raising capital from debt and equity sources – from borrowing money from banks and other sources willing to loan money to the business and from its owners putting additional money in the business. In addition, the term includes making payments on debt and returning capital to owners. *Financing* also refers to cash distributions (if any) from profit by the business to its owners.

Most businesses borrow money for a short term (generally defined as less than one year), as well as for longer terms (generally defined as more than one year). In other words, a typical business has both short-term and long-term debt. (Chapter 6 explains that short-term debt is presented in the current liabilities section of the balance sheet.) The business in our example has both short-term and long-term debt. Although not a hard-and-fast rule, most cash flow statements report just the *net* increase or decrease in short-term debt, not the total amount borrowed and the total payments on short-term debt during the period. In contrast, both the total amount borrowed and the total amount paid on long-term debt during the year are reported in the cash flow statement.

For the business we've been using as an example, no long-term debt was paid down during the year but short-term debt was paid off during the year and replaced with new short-term notes payable. However, only the net increase (£200,000) is reported in the cash flow statement. The business also increased its long-term debt by £300,000 (refer to Figure 7-2).

The financing section of the cash flow statement also reports on the flow of cash between the business and its owners (who are the stockholders of a corporation). Owners can be both a *source* of a business's cash (capital invested by owners) and a *use* of a business's cash (profit distributed to owners). This section of the cash flow statement reports capital raised from its owners, if any, as well as any capital returned to the owners. In the cash flow statement (Figure 7–2), note that the business did issue additional stock shares for £60,000 during the year, and it paid a total of £400,000 cash dividends (distributions) from profit to its owners.

Free Cash Flow: What on Earth Does That Mean?

A new term has emerged in the lexicon of accounting and finance – *free cash flow.* This piece of language is not – we repeat, *not* – an officially defined term by any authoritative accounting rule-making body. Furthermore, the term does *not* appear in the cash flow statements reported by businesses. Rather, free cash flow is street language, or slang, even though the term appears often in *The Financial Times* and *The*

Economist. Securities brokers and investment analysts use the term freely (pun intended). Like most new words being tossed around for the first time, this one hasn't settled down into one universal meaning although the most common usage of the term pivots on cash flow from profit.

The term *free cash flow* is used to mean any of the following:

- Net income plus depreciation (plus any other expense recorded during the period that does not involve the outlay of cash but rather the allocation of the cost of a long-term asset other than property, plant and equipment – such as the intangible assets of a business).
- Cash flow from operating activities (as reported in the cash flow statement).
- Cash flow from operating activities minus some or all of the capital expenditures made during the year (such as purchases or construction of new, long-lived operating assets such as property, plant and equipment).
- Cash flow from operating activities plus interest, and depreciation, and income tax expenses, or, in other words, cash flow before these expenses are deducted.

In the strongest possible terms, we advise you to be very clear on which definition of *free cash flow* the speaker or writer is using. Unfortunately, you can't always determine what the term means in any given context. The reporter or investment professional should define the term.

One definition of free cash flow, in our view, is quite useful: cash flow from profit minus capital expenditures for the year. The idea is that a business needs to make capital expenditures in order to stay in business and thrive. And to make capital expenditures, the business needs cash. Only after paying for its capital expenditures does a business have ‘free’ cash flow that it can use as it likes. In our example, the free cash flow is, in fact, negative – £1,100,000 cash flow from profit minus £1,275,000 capital expenditures for new fixed assets equals a *negative* £175,000.

TIP

This is a key point. In many cases, cash flow from profit falls short of the money needed for capital expenditures. So the business has to borrow more money, persuade its owners to invest more money in the business, or dip into its cash reserve. Should a business in this situation distribute some of its profit to owners? After all, it has a cash *deficit* after paying for capital expenditures. But many companies like the business in our example do, in fact, make cash distributions from profit to their owners.

Scrutinising the Cash Flow Statement

Analysing a business’s cash flow statement inevitably raises certain questions: What would I have done differently if I were running this business? Would I have borrowed more money? Would I have raised more money from the owners? Would I have distributed so much of the profit to the owners? Would I have let my cash balance drop by even such a small amount?

One purpose of the cash flow statement is to show readers what judgment calls and financial decisions the business's managers made during the period. Of course, management decisions are always subject to second- guessing and criticising, and passing judgment based on a financial statement isn't totally fair because it doesn't reveal the pressures the managers faced during the period. Maybe they made the best possible decisions given the circumstances. Maybe not.

REAL WORLD EXAMPLE

The business in our example (refer to Figure 7-2) distributed $400,000 cash from profit to its owners – a 25 per cent *pay-out ratio* (which is the $400,000 distribution divided by $1.6 million net income). In analysing whether the pay-out ratio is too high, too low or just about right, you need to look at the broader context of the business's sources of, and needs for, cash.

First look at cash flow from profit: $1.1 million, which is not enough to cover the business's $1,275,000 capital expenditures during the year. The business increased its total debt $500,000. Given these circumstances, maybe the business should have hoarded its cash and not paid so much in cash distributions to its owners.

So does this business have enough cash to operate with? You can't answer that question just by examining the cash flow statement – or any financial statement for that matter. Every business needs a buffer of cash to protect against unexpected developments and to take advantage of unexpected opportunities, as we explain in Chapter 10 on budgeting. This particular business has a £2 million cash balance compared with £25 million annual sales revenue for the period just ended, which probably is enough. If you were the boss of this business how much working cash balance would you want? Not an easy question to answer! Don't forget that you need to look at all three primary financial statements – the profit and loss account and the balance sheet as well as the cash flow statement – to get the big picture of a business's financial health.

You probably didn't count the number of lines of information in Figure 7-2, the cash flow statement for the business example. Anyway, the financial statement has 17 lines of information. Would you like to hazard a guess regarding the average number of lines in cash flow statements of publicly owned companies? Typically, their cash flow statements have 30 to 40 lines of information by our reckoning. So it takes quite a while to read the cash flow statement – more time than the average investor probably has. (Professional stock analysts and investment managers are paid to take the time to read this financial statement meticulously.) Quite frankly, we find that many cash flow statements are not only rather long but also difficult to understand – even for an accountant. We won't get on a soapbox here but we definitely think businesses could do a better job of reporting their cash flow statements by reducing the number of lines in their financial statements and making each line clearer.

TIP The website www.score.org offers a downloadable Excel spreadsheet that enables you to tailor a cash flow statement to your requirements. You can find the spreadsheet by going to the SCORE homepage and clicking on ‘Templates & Tools’ where you can find an extensive selection of templates and calculators. Microsoft also has a comprehensive range of templates at http://office.microsoft.com/en-gb/Templates followed by a search term, in this case ‘cash flow’.

Chapter 8

Getting a Financial Report Ready for Prime Time

In This Chapter

- Making sure that all the pieces fit together
- Looking at the various changes in owners' equity
- Making sure that disclosure is adequate
- Touching up the numbers
- Financial reporting on the Internet
- Dealing with financial reports' information overload

The primary financial statements of a business (as explained in Chapters 5, 6 and 7) are:

- **Profit and loss account:** Summarises sales revenue inflows and expense outflows for the period and ends with the bottom-line profit, which is the net inflow for the period (a loss is a net outflow).
- **Balance sheet:** Summarises financial condition at the end of the period, consisting of amounts for assets, liabilities and owners' equity at that instant in time.
- **Cash flow statement:** Summarises the net cash inflow (or outflow) from profit for the period plus the other sources and uses of cash during the period.

An annual financial report of a business contains more than just these three financial statements. In the 'more', the business manager plays an important role – which outside investors and lenders should understand. The manager should do certain critical things before the financial report is released to the outside world.

1. **The manager should review with a critical eye the *vital connections* between the items reported in all three financial statements** – all amounts have to fit together like the pieces of a jigsaw. The net cash increase (or decrease) reported at the end of the cash flow statement, for instance, has to tie in with the change in cash reported in the balance sheet. Abnormally high or low ratios between connected accounts should be scrutinised carefully.
2. **The manager should carefully review the *disclosures* in the financial report** (all information in addition to the financial statements) to make sure that disclosure is adequate according to financial reporting standards, and that all the disclosure elements are truthful but not damaging to the interests of the business.

   This disclosure review can be compared with the notion of *due diligence*, which is done to make certain that all relevant information is collected, that the information is accurate and reliable, and that all relevant requirements and regulations are being complied with. This step is especially important for public corporations whose securities (shares and debt instruments) are traded on national securities exchanges.
3. **The manager should consider whether the financial statement numbers need *touching up*** to smooth the jagged edges off the company's year-to-year profit gyrations or to improve the business's short-term solvency picture. Although this can be described as putting your thumb on the scale, you

can also argue that sometimes the scale is a little out of balance to begin with and the manager is adjusting the financial statements to jibe better with the normal circumstances of the business.

In discussing the third step later in the chapter, we walk on thin ice. Some topics are, shall we say, rather delicate. The manager has to strike a balance between the interests of the business on the one hand and the interests of the owners (investors) and creditors of the business on the other. The best analogy we can think of is the advertising done by a business. Advertising should be truthful but, as we're sure you know, businesses have a lot of leeway in how to advertise their products and they have been known to engage in hyperbole. Managers exercise the same freedoms in putting together their financial reports.

Reviewing Vital Connections

Business managers and investors read financial reports because these reports provide information regarding how the business is doing. The top managers of a business, in reviewing the annual financial report before releasing it outside the business, should keep in mind that a financial report is designed to answer certain basic financial questions:

- Is the business making a profit or suffering a loss, and how much?
- How do assets stack up against liabilities?
- Where did the business get its capital and is it making good use of the money?
- Is profit generating cash flow?
- Did the business reinvest all its profit or distribute some of the profit to owners?
- Does the business have enough capital for future growth?

As a hypothetical but realistic business example, Figure 8-1 highlights some of the vital connections – the lines connect one or more balance sheet accounts with sales revenue or an expense in the profit and loss account. The savvy manager or investor checks these links to see whether everything is in order or whether some danger signals point to problems. (We should make clear that these lines of connection do not appear in actual financial reports.)

Figure 8-1: Vital connections between the profit and loss account and the balance sheet.

(Amounts in thousands)

Profit and Loss Account for Year

Sales Revenue	£ 52,000
Cost of Goods Sold Expense	31,200
Gross Margin	£ 20,800
Sales, Administration, and General Expenses	15,600
Depreciation Expense	1,650
Earnings Before Interest and Income Tax	£ 3,550
Interest Expense	750
Earnings Before Income Tax	£ 2,800
Income Tax Expense	900
Net Income	£ 1,900

Balance Sheet at End of Year

Assets	
Cash	£ 3,500
Debtors	5,000
Stock	7,800
Prepaid Expenses	900
Fixed Assets	19,500
Accumulated Depreciation	(6,825)
Total Assets	£ 29,875
Liabilities	
Creditors	£ 1,500
Accrued Expenses Payable	2,400
Income Tax Payable	75
Overdraft	4,000
Long Term Loans	6,000
Owners' Equity	
Share Capital	4,000
Retained Earnings	11,900
Liabilities and Owners' Equity	£ 29,875

In the following list, we briefly explain these five connections, mainly from the manager's point of view. Chapters 14 and 17 explain how investors and lenders read a financial report and compute certain ratios. (Investors and lenders are on the outside looking in; managers are on the inside looking out.)

Note: We cut right to the chase in the following brief comments and we do not illustrate the calculations behind the comments. The purpose here is to emphasise why managers should pay attention to these important ratios. (Chapters 5 and 6 provide fuller explanations of these and other connections of operating assets and liabilities with sales revenue and expenses.)

1. **Sales Revenue and Debtors:** This business's ending balance of debtors is five weeks of its annual sales revenue. The manager should compare this ratio to the normal credit terms offered to the business's customers. If the ending balance is too high, the manager should identify which customers' accounts are past due and take actions to collect these amounts, or perhaps shut off future credit to these customers. An abnormally high balance of debtors may signal that some of these customers' amounts owed to the business should be written off as uncollectable bad debts.

2. Cost of Goods Sold Expense and Stock: This business's ending stock is 13 weeks of its annual cost of goods sold expense. The manager should compare this ratio to the company's stock policies and objectives regarding how long stock should be held awaiting sale. If stock is too large the manager should identify which products have been in stock too long; further purchases (or manufacturing) should be curtailed. Also, the manager may want to consider sales promotions or cutting sales prices to move these products out of stock faster.

3. Sales, Administration and General (SA&G) Expenses and Prepaid Expenses: This business's ending balance of prepaid expenses is three weeks of the total of these annual operating expenses. The manager should know what the normal ratio of prepaid expenses should be relative to the annual SA&G operating expenses (excluding depreciation expense). If the ending balance is too high, the manager should investigate which costs have been paid too far in advance and take action to bring these prepaids back down to normal.

4. Sales, Administration and General (SA&G) Expenses and Creditors: This business's ending balance of creditors is five weeks of its annual operating expenses. Delaying payment of these liabilities is good from the cash flow point of view (refer to Chapter 7) but delaying too long may jeopardise the company's good credit rating with its key suppliers and vendors. If this ratio is too high, the manager should pinpoint which specific liabilities have not been paid and whether any of these are overdue and should be paid immediately. Or, the high balance may indicate that the company is in a difficult short-term solvency situation and needs to raise more money to pay the amounts owed to suppliers and vendors.

5. Sales, Administration and General (SA&G) Expenses and Accrued Expenses Payable: This business's ending balance of this operating liability is eight weeks of the business's annual operating expenses. This ratio may be consistent with past experience and the normal lag before paying these costs. On the other hand, the ending balance may be abnormally high. The manager should identify which of these unpaid costs are higher than they should be. As with creditors, inflated amounts of accrued liabilities may signal serious short-term solvency problems.

These five key connections are very important ones, but the manager should scan all basic connections to see whether the ratios pass the common sense test. For example, the manager should make a quick eyeball test of interest expense compared with interest-bearing debt. In Figure 8-1, interest expense is £750,000 compared with £10 million total debt, which indicates a 7.5 per cent interest rate. This seems OK. But if the interest expense were more than £1 million, the manager should investigate and determine why it's so high.

There's always the chance of errors in the accounts of a business. Reviewing the vital connections between the profit and loss account items and the balance sheet items is a very valuable final check before the financial statements are approved for inclusion in the business's financial report. After the financial report is released to the outside world, it becomes the latest chapter in the official financial history of the business. If the financial statements are wrong, the business and its top managers are responsible.

Statement of Changes in Owners' Equity and Comprehensive Income

In many situations a business needs to prepare one additional financial statement – the *statement of changes in owners' equity.* Owners' equity consists of two fundamentally different sources – capital invested in the business by the owners, and profit earned by and retained in the business. The specific accounts maintained by the business for its total owners' equity depend on the legal organisation of the business entity. One of the main types of legal organisation of business is the *company*, and its owners are *shareholders* because the company issues ownership *shares* representing portions of the business. So, the title *statement of changes in shareholders' equity* is used for companies. (Chapter 11 explains the corporation and other legal types of business entities.)

First, consider the situation in which a business does *not* need to report this statement – to make clearer why the statement is needed. Suppose a company has only one class of share and it did not buy any of its own shares during the year and it did not record any gains or losses in owners' equity during the year due to *other comprehensive income* (explained below). This business does not need a statement of changes in shareholders' equity. In reading the financial report of this business you would see in its cash flow statement (Figure 7–2 shows an example) whether the business raised additional capital from its owners during the year and how much in *cash dividends* (distributions from profit) was paid to the owners during the year. The cash flow statement contains all the changes in the owners' equity accounts during the year.

In sharp contrast, larger businesses – especially publicly traded corporations – generally have complex ownership structures consisting of two or more classes of shares; they usually buy some of their own shares and they have one or more technical types of gains or losses during the year. So, they prepare a statement of changes in stockholders' equity to collect together in one place all the changes affecting the owners' equity accounts during the year. This particular 'mini' statement (that focuses narrowly on changes in owners' equity accounts) is where you find certain gains and losses that increase or decrease owners' equity but which are *not* reported in the profit and loss account. Basically, a business has the option to bypass the profit and loss account and, instead, report these gains and losses in the statement of changes in owners' equity. In this way the gains or losses do not affect the bottom-line profit of the business reported in its profit and loss account. You have to read this financial summary of the changes in the owners' equity accounts to find out whether the business had any of these gains or losses and the amounts of the gains or losses.

The special types of gains and losses that can be reported in the statement of owners' equity (instead of the profit and loss account) have to do with foreign currency translations, unrealised gains and losses from certain types of securities investments by the business and changes in liabilities for unfunded pension fund obligations of the business. *Comprehensive income* is the term used to describe the normal content of the profit and loss account *plus* the additional layer of these special types of gains and losses. Being so technical in nature, these gains and losses fall in a 'twilight zone' as it were, in financial reporting. The gains and losses can be tacked on at the bottom of the profit and loss account or they can be put in the statement of changes in owners' equity – it's up to the business to make the choice. If you encounter these gains and losses in reading a financial report, you'll have to study the footnotes to the financial statements to learn more information about each gain and loss.

Keep on the lookout for the special types of gains and losses that are reported in the statement of changes in owners' equity. A business has the option to tack such gains and losses onto the bottom of its profit and loss account – below the net income line. But, most businesses put these income gains and losses in their statement of changes in shareholders' equity, or in a note or notes to their accounts. So, watch out for any large amounts of gains or losses that are reported in the statement of changes in owners' equity.

The general format of the statement of changes in shareholders' equity includes a column for each class of stock (ordinary shares, preference shares and so on); a column for any shares of its own that the business has purchased and not cancelled; a column for retained earnings; and one or more columns for any other separate components of the business's owners' equity. Each column starts with the beginning balance and then shows the increases or decreases in the account during the year. For example, a comprehensive gain is shown as an increase in retained earnings and a comprehensive loss as a decrease. The purchase of its own shares is shown as an increase in the relevant column and if the business reissued some of these shares (such as for stock options exercised by executives), the cost of these shares reissued is shown as a decrease in the column.

We have to admit that reading the statement of changes, or *notes to the accounts* in shareholders' equity can be heavy going. The professionals – stock analysts, money and investment managers and so on – carefully read through and dissect this statement, or at least they should. The average non-professional investor should focus on whether the business had a major increase or decrease in the number of shares during the year, whether the business changed its ownership structure by creating or eliminating a class of stock, and the impact of stock options awarded to managers of the business.

Making Sure that Disclosure Is Adequate

The primary financial statements (including the statement of changes in owners' equity, if reported) are the backbone of a financial report. In fact, a financial report is not deserving of the name if the primary financial statements are not included. But, as mentioned earlier, there's much more to a financial report than the financial statements. A financial report needs *disclosures.* Of course, the financial statements provide disclosure of the most important financial information about the business. The term disclosures, however, usually refers to additional information provided in a financial report. In a nutshell, a financial report has two basic parts: (1) the primary financial statements and (2) disclosures.

The chief officer of the business (usually the CEO of a publicly owned company, the president of a private corporation or the managing partner of a partnership) has the primary responsibility to make sure that the financial statements have been prepared according to prevailing accounting standards and that the financial report provides adequate disclosure. He or she works with the chief financial officer of the business to make sure that the financial report meets the standard of adequate disclosure. (Many smaller businesses hire an independent qualified accountant to advise them on their financial statements and other disclosures in their financial reports.)

Types of disclosures in financial reports

For a quick survey of disclosures in financial reports – that is to say, the disclosures in addition to the financial statements – the following distinctions are helpful:

- **Footnotes** that provide additional information about the basic figures included in the financial statements; virtually all financial statements need footnotes to provide additional information for the account balances in the financial statements.
- **Supplementary financial schedules and tables** that provide more details than can be included in the body of financial statements.
- A wide variety of **other information**, some of which is required if the business is a company quoted on a stock market subject to government regulations regarding financial reporting to its shareholders and other information that is voluntary and not strictly required legally or according to GAAP.

Footnotes: Nettlesome but needed

Footnotes appear at the end of the primary financial statements. Within the financial statements you see references to particular footnotes. And at the bottom of each financial statement, you find the following sentence (or words to this effect): ‘The footnotes are integral to the financial statements.’ You should read all footnotes for a full understanding of the financial statements.

Footnotes come in two types:

- One or more footnotes must be included to identify the **major accounting policies and methods** that the business uses. (Chapter 13 explains that a business must choose among alternative accounting methods for certain expenses, and for their corresponding operating assets and liabilities.) The business must reveal which accounting methods it uses for its major expenses. In particular, the business must identify its cost of goods sold expense (and stock) method and its depreciation methods.
- Other footnotes provide **additional information and details** for many assets and liabilities. Details about share option plans for key executives are the main type of footnote to the capital stock account in the owners’ equity section of the balance sheet.

One problem that most investors face when reading footnotes – and, for that matter, many managers who should understand their own footnotes but find them a little dense – is that footnotes often deal with complex issues (such as lawsuits) and rather technical accounting matters. Let us offer you one footnote that brings out this latter point. This footnote is taken from the recent financial report of a well-known manufacturer that uses a very conservative accounting method for determining its cost of goods sold expense and stock cost value. We know that we have not yet talked about these accounting methods; this is deliberate on our part. (Chapter 13 explains accounting methods.) We want you to read the following footnote from the 2011 Annual Report of this manufacturer and try to make sense of it (amounts are in thousands).

> ***D. Inventories****: Inventories are valued principally by the LIFO (last-in, first-out) method. If the FIFO (first-in, first-out) method had been in use, inventories would have been £2,000 million and £1,978 million higher than reported at December 31, 2010 and 2011, respectively.*

Yes, these amounts are in *millions* of pounds. The company's stock cost value at the end of 2010 would have been £2 billion higher if the FIFO method had been used. Of course, you have to have some idea of the difference between the two methods, which we explain in Chapter 13.

You may wonder how different the company's annual profits would have been if the alternative method had been in use. A manager can ask the accounting department to do this analysis. But, as an outside investor, you would have to compute these amounts. Businesses disclose which accounting methods they use but they do not have to disclose how different annual profits would have been if the alternative method had been used – and very few do.

Other disclosures in financial reports

The following discussion includes a fairly comprehensive list of the various types of disclosures found in annual financial reports of larger, publicly owned businesses – in addition to footnotes. A few caveats are in order. First, not every public company includes every one of the following items although the disclosures are fairly common. Second, the level of disclosure by private businesses – after you get beyond the financial statements and footnotes – is much less than in public companies. Third, tracking the actual disclosure practices of private businesses is difficult because their annual financial reports are circulated only to their owners and lenders. A private business may include any or all of the following disclosures but, by and large, it is not legally required to do so. The next section further explains the differences between private and public businesses regarding disclosure practices in their annual financial reports.

Warren Buffett's annual letter to shareholders

We have to call your attention to one notable exception to the generally self-serving and slanted writing found in the letter to shareholders by the chief executive officer of the business in annual financial reports. The annual letter to stockholders of Berkshire Hathaway, Inc. is written by Warren Buffett, the Chairman and CEO. Mr Buffett has become very well known – he's called the 'Oracle of Omaha'. In the annual ranking of the world's richest people by *Forbes* magazine he is near the top of the list – right behind people like Bill Gates, the co-founder of Microsoft. If you had invested £1,000 with him in 1960, your investment would be worth well over £1,000,000 today. Even in the recent financial meltdown Berkshire Hathaway stock delivered a return of nearly 80% over the period 2000–2011 compared to a negative 12% return for the S&P 500. Mr Buffett's letters are the epitome of telling it like it is; they are very frank and quite humorous.

You can go to the website of the company (www.berkshirehathaway.com) and download his most recent letter. You'll learn a lot about his investing philosophy and the letters are a delight to read.

Public corporations typically include most of the following disclosures in their annual financial reports to their shareholders:

- **Cover (or transmittal) letter):** A letter from the chief executive of the business to the shareholders.
- **Highlights table:** A short table that presents the shareholder with a financial thumbnail sketch of the business.
- **Management discussion and analysis (MD&A):** Deals with the major developments and changes during the

year that affected the financial performance and situation of the business.

- **Segment information:** The sales revenue and operating profits are reported for the major divisions of the organisation or for its different markets (international versus domestic, for example).
- **Historical summaries:** Financial history that extends back beyond the years (usually three but can be up to five or six) included in the primary financial statements.
- **Graphics:** Bar charts, trend charts and pie charts representing financial conditions; photos of key people and products.
- **Promotional material:** information about the company, its products, its employees and its managers, often stressing an over-arching theme for the year.
- **Profiles:** Information about members of top management and the board of directors.
- **Quarterly summaries of profit performance and share prices and dividends:** Shows financial performance for all four quarters in the year and share price ranges for each quarter.
- **Management's responsibility statement:** A short statement that management has primary responsibility for the accounting methods used to prepare the financial statements and for providing the other disclosures in the financial report.
- **Independent auditor's report:** The report from the accounting firm that performed the audit, expressing an opinion on the fairness of the financial statements and accompanying disclosures. (Chapter 15 discusses the nature of audits.) Public companies are required to have

audits; private businesses may or may not have their annual financial reports audited depending on their size.

- **Company contact information:** Information on how to contact the company, the website address of the company, how to get copies of the reports filed with the London Stock Exchange, SEC, the stock transfer agent and registrar of the company, and other information.

WARNING!

Managers of public corporations rely on lawyers, auditors and their financial and accounting officers to make sure that everything that should be disclosed in the business's annual financial reports is included and that the exact wording of the disclosures is not misleading, inaccurate or incomplete. This is a tall order. The field of financial reporting disclosure changes constantly. Laws, as well as authoritative accounting standards, have to be observed. Inadequate disclosure in an annual financial report is just as serious as using wrong accounting methods for measuring profit and for determining values for assets, liabilities and owners' equity. A financial report can be misleading because of improper accounting methods or because of inadequate or misleading disclosure. Both types of deficiencies can lead to nasty lawsuits against the business and its managers.

TIP

Companies House provides forms showing how the Companies Act requires balance sheets and profit and loss accounts to be laid out. To access their guidance, go to www.companieshouse.gov.uk/forms/introduction.shtml. All their statutory forms are available on request and free of charge.

Keeping It Private versus Going Public

Compared with their big brothers and sisters, privately owned businesses provide very little additional disclosures in their annual financial reports. The primary financial statements and footnotes are pretty much all you get.

The annual financial reports of publicly owned corporations include all, or nearly all, of the disclosure items listed earlier. Somewhere in the range of 3,000 companies are publicly owned, and their shares are traded on the London Stock Exchange, NASDAQ or other stock exchanges. Publicly owned companies must file annual financial reports with the Stock Exchange, which is the agency that makes and enforces the rules for trading in securities and for the financial reporting requirements of publicly owned corporations. These filings are available to the public on the London Stock Exchange's website (www.londonstockexchange.com) or for US companies on the Securities Exchange Commission's (SEC's) EDGAR database at the SEC's website – www.sec.gov/edgar/searchedgar/cik.htm.

Both privately held and publicly owned businesses are bound by the same accounting rules for measuring profit, assets, liabilities and owners' equity in annual financial reports to the owners of the business and in reports that are made available to others (such as the lenders to the business). There aren't two different sets of accounting rules – one for private companies and another one for public businesses. The accounting measurement and valuation rules are the same for all businesses. However, *disclosure* requirements and practices differ greatly between private and public companies.

Publicly owned businesses live in a fish bowl. When a company goes public with an *IPO* (initial public offering of shares), it gives up a lot of the privacy that a closely held business enjoys. Publicly owned companies whose shares are traded on national stock exchanges live in glass houses. In contrast, privately owned businesses lock their doors regarding disclosure. Whenever a privately owned business releases a financial report to its bank in seeking a loan, or to the outside non-management investors in the business, it should include its three primary financial statements and footnotes. But beyond this, they have much more leeway and do not have to include the additional disclosure items listed in the preceding section.

A private business may have its financial statements audited by a professional accounting firm. If so, the audit report is included in the business's annual financial report. The very purpose of having an audit is to reassure shareholders and potential investors in the business that the financial statements can be trusted. But as we look up and down the preceding list of disclosure items we don't see any other absolutely required disclosure item for a privately held business. The large majority of closely held businesses guard their financial information like Fort Knox.

The less information divulged in the annual financial report, the better – that's their thinking. And we don't entirely disagree. The shareholders don't have the liquidity for their shares that shareholders of publicly held corporations enjoy. The market prices of public companies are everything, so information is made publicly available so that market prices are fairly determined. The shares of privately owned businesses are rarely traded, so there is not such an urgent need for a complete package of information.

A private company could provide all the disclosures given in the preceding list – there's certainly no law against this. But usually they don't. Investors in private businesses can request confidential reports from managers at the annual shareholders' meetings, but doing so is not practical for a shareholder in a large public corporation.

Nudging the Numbers

This section discusses two accounting tricks that business managers and investors should know about. We don't endorse either technique, but you should be aware of both of them. In some situations, the financial statement numbers don't come out exactly the way the business wants. Accountants use certain tricks of the trade – some would say sleight-of-hand – to move the numbers closer to what the business prefers. One trick improves the appearance of the *short-term solvency* of the business, in particular the cash balance reported in the balance sheet at the end of the year. The other device shifts profit from one year to the next to make for a smoother trend of net income from year to year.

Not all businesses use these techniques, but the extent of their use is hard to pin down because no business would openly admit to using these manipulation methods.

The evidence is fairly convincing, however, that many businesses use these techniques. We're sure you've heard the term *loopholes* applied to income tax accounting. Well, some loopholes exist in financial statement accounting as well.

Fluffing up the cash balance by 'window dressing'

Suppose you manage a business and your accountant has just submitted to you a preliminary, or first draft, of the year-end balance sheet for your review. (Chapter 6 explains the balance sheet, and Figure 6-1 shows a complete balance sheet for a business.) Your preliminary balance sheet includes the following:

Preliminary Balances, Before Window Dressing

Cash	£0	Creditors	£235,000
Debtors	£486,000	Accrued expenses payable	£187,000
Stock	£844,000	Income tax payable	£58,000
Overdraft	£200,000		
Prepaid expenses	£72,000		
Current assets	£1,402,000	Current liabilities	£680,000

You start reading the numbers when something strikes you: a zero cash balance? How can that be? Maybe your business has been having some cash flow problems and you've intended to increase your short-term borrowing and speed up collection of debtors to help the cash balance. But that plan doesn't help you right now, with this particular financial report that you must send out to your business's investors and your banker. Folks generally don't like to see a zero cash balance – it makes them kind of nervous, to put it mildly, no matter how you try to cushion it. So what do you do to avoid alarming them?

Your accountant is probably aware of a technique known as *window dressing*, a very simple method for making the cash balance look better. Suppose your financial year-end is October 31. Your accountant takes the cash receipts from customers paying their bills that are actually received on November 1, 2 and 3, and records them as if these cash collections had been received on October 31. After all, the argument can be made that the customers' cheques were in the mail – that money is yours, as far as the customers are concerned, so your reports should reflect that cash inflow.

What impact does window dressing have? It reduces the amount in debtors and increases the amount in cash by the same amount – it has absolutely no effect on the profit figure. It just makes your cash balance look a touch better. Window dressing can also be used to improve other accounts' balances, which we don't go into here. All of these techniques involve holding the books open to record certain events that take place after the end of the financial year (the ending balance sheet date) to make things look better than they actually were at the close of business on the last day of the year.

WARNING!

Sounds like everybody wins, doesn't it? Your investors don't panic and your job is safe. We have to warn you, though, that window dressing may be the first step on a slippery slope. A little window dressing today and tomorrow, who knows? – Maybe giving the numbers a nudge will lead to serious financial fraud. Any way you look at it, window dressing is deceptive to your investors who have every right to expect that the end of your fiscal year as stated on your financial reports is truly the end of your fiscal year. Think about it this way: If you've invested in a business that has fudged this data, how do you know what other numbers on the report are suspect?

Smoothing the rough edges off profit

Managers strive to make their numbers and to hit the milestone markers set for the business. Reporting a loss for the year, or even a dip below the profit trend line, is a red flag that investors view with alarm.

JARGON ALERT

Managers can do certain things to deflate or inflate profit (the net income) recorded in the year, which are referred to as *profit-smoothing* techniques. Profit smoothing is also called *income smoothing.* Profit smoothing is not nearly as serious as *cooking the books*, or *juggling the books*, which refers to deliberate, fraudulent accounting practices such as recording sales revenue that has not happened or not recording expenses that have happened. Cooking the books is very serious; managers can go to jail for fraudulent financial statements. Profit smoothing is more like a white lie that is told for the good of the business, and perhaps for the good of managers as well. Managers know that there is always some noise in the accounting system. Profit smoothing muffles the noise.

Managers of publicly owned companies whose shares are actively traded are under intense pressure to keep profits steadily rising. Security analysts who follow a particular company make profit forecasts for the business, and their buy-hold-sell recommendations are based largely on these earnings forecasts. If a business fails to meet its own profit forecast or falls short of analysts' forecasts, the market price of its shares suffers. Share option and bonus incentive compensation plans are also strong motivations for achieving the profit goals set for the business.

The evidence is fairly strong that publicly owned businesses engage in some degree of profit smoothing. Frankly, it's much harder to know whether private businesses do so. Private businesses don't face the public scrutiny and expectations that public corporations do. On the other hand, key managers in a private business may have incentive bonus arrangements that depend on recorded profit. In any case, business investors and managers should know about profit smoothing and how it's done.

Most profit smoothing involves pushing revenue and expenses into other years than they would normally be recorded. For example, if the president of a business wants to report more profit for the year, he or she can instruct the chief accountant to accelerate the recording of some sales revenue that normally wouldn't be recorded until next year, or to delay the recording of some expenses until next year that normally would be recorded this year. The main reason for smoothing profit is to keep it closer to a projected trend line and make the line less jagged.

Chapter 13 explains that managers choose among alternative accounting methods for several important expenses. After making these key choices the managers should let the accountants do their jobs and let the chips fall where they may. If bottom-line profit for the year turns out to be a little short of the forecast or target for the period, so be it. This hands-off approach to profit accounting is the ideal way. However, managers often use a hands-on approach – they intercede (one could say interfere) and override the normal accounting for sales revenue or expenses.

Both managers who do it and investors who rely on financial statements in which profit smoothing has been done should definitely understand one thing – these techniques have robbing-Peter-to-pay-Paul effects. Accountants refer to these as *compensatory effects.* The effects on next year's statement simply offset and cancel out the effects on this year. Less expense this year is counterbalanced by more expense next year. Sales revenue recorded this year means less sales revenue recorded next year.

Two profit histories

Figure 8-2 shows, side by side, the annual profit histories of two different companies over six years. Business X shows a nice steady upward trend of profit. Business Y, in contrast, shows somewhat of a rollercoaster ride over the six years. Both businesses earned the same total profit for the six years – in this case, £1,050,449. Their total six-year profit performance is the same, down to the last pound. Which company would you be more willing to risk your money in? We suspect that you'd prefer Business X because of the steady upward slope of its profit history.

Question: Does Figure 8-2 really show two different companies – or are the two profit histories actually alternatives for the same company? The year-by- year profits for Business X could be the company's *smoothed* profit, and the annual profits for Business Y could be the *actual* profit of the same business – the profit that would have been recorded if smoothing techniques had not been applied.

For the first year in the series, 2006, no profit smoothing occurred. Actual profit is on target. For each of the next five years, the two profit numbers differ. The under-gap or over-gap of actual profit compared with smoothed profit for the year is the amount of revenue or expenses manipulation that was done in the year. For example, in 2007, actual profit would have been too high, so the company moved some expenses that normally would be recorded the following year into 2007. In contrast, in 2008, actual profit was running too low, so the business took action to put off recording some expenses until 2011.

If a business has a particularly bad year, all the profit-smoothing tricks in the world won't close the gap. But several smoothing techniques are available for filling the potholes and straightening the curves on the profit highway.

Profit-smoothing techniques

One common technique for profit smoothing is *deferred maintenance.* Many routine and recurring maintenance costs required for vehicles, machines, equipment and buildings can be put off, or deferred until later. These costs are not recorded to expense until the actual maintenance is done, so putting off the work means that no expense is recorded. Or a company can cut back on its current year's outlays for market research and product development. Keep in mind that most of these costs will be incurred next year, so the effect is to rob Peter (make next year absorb the cost) to pay Paul (let this year escape the cost).

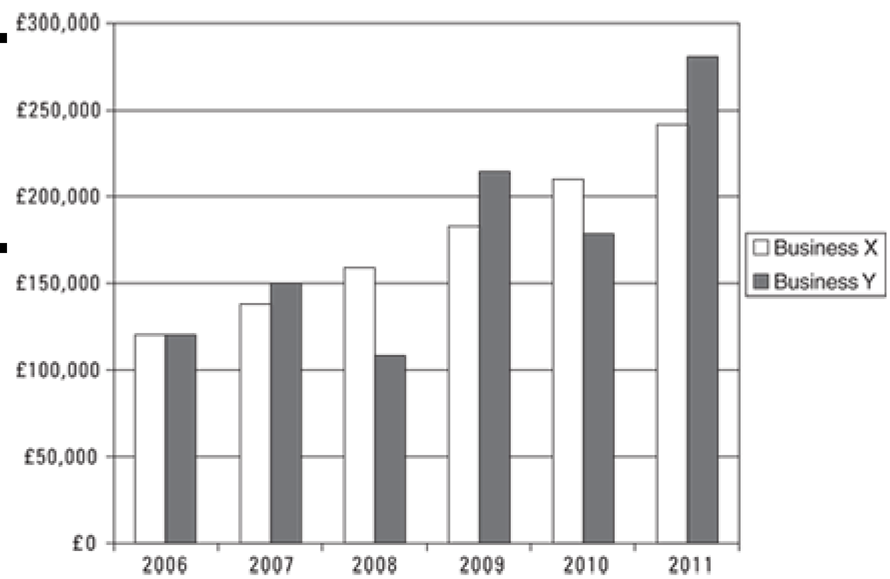


Figure 8-2: Comparison of two annual profit histories.

A business can ease up on its rules regarding when slow-paying customers are decided to be bad debts (uncollectable debtors). A business can put off recording some of its bad debts expense until next year. A fixed asset out of active use may have very little or no future value to a business. Instead of writing off the non-depreciated cost of the *impaired asset* as a loss this year, the business may delay the write-off until next year.

So, managers have control over the timing of many expenses, and they can use this discretion for profit smoothing. Some amount of expenses can be accelerated into this year or deferred to next year in order to make for a smoother profit trend. Of course, in its external financial report a business does not divulge the extent to which it has engaged in profit smoothing. Nor does the independent auditor comment on the use of profit-smoothing techniques by the business – unless the auditor thinks that the company has gone too far in massaging the numbers and that its financial statements are misleading.

Sticking to the accounting conventions

Over time, a generally accepted approach to the boundaries of acceptable number nudging has been arrived at. This hinges on the use of three conventions: conservatism, materiality and consistency.

Conservatism

Accountants are often viewed as merchants of gloom, always prone to taking a pessimistic point of view. The fact that a point of view has to be taken at all is the root of the problem. The convention of *conservatism* means that, given a choice, the accountant takes the figure that will result in a lower end profit. This might mean, for example, taking the higher of two possible expense figures. Few people are upset if the profit figure at the end of the day is higher than earlier estimates. The converse is never true.

Materiality

A strict interpretation of depreciation could lead to all sorts of trivial paperwork. For example, pencil sharpeners, staplers and paperclips, all theoretically items of fixed assets, should be depreciated over their working lives. This is obviously a useless exercise and in practice these items are written-off when they are bought.

Clearly, the level of *materiality* is not the same for all businesses. A multinational may not keep meticulous records of every item of machinery under $1,000. For a small business this may represent all the machinery it has.

Consistency

Even with the help of those concepts and conventions, there's a fair degree of latitude in how you can record and interpret financial information. You need to choose the methods that give the fairest picture of how the firm is performing and stick with them. Keeping track of events in a business that's always changing its accounting methods is very difficult. This doesn't mean that you're stuck with one method forever. Any change, however, is an important step.

Browsing versus Reading Financial Reports

Very few people have the time to carefully read all the information in an annual financial report – even if the report is relatively short.

Annual financial reports are long and dense documents – like lengthy legal contracts in many ways. Pick up a typical annual financial report of a public corporation: You would need many hours (perhaps the whole day) to thoroughly read everything in the report. You would need at least an hour or two just to read and absorb the main points in the report. How do investors in a business deal with the *information overload* of annual financial reports put out by businesses?

An annual financial report is like the Sunday edition of *The Times* or *The Telegraph*. Hardly anyone reads every sentence on every page of these Sunday papers – most people pick and choose what they want to read. Investors read annual financial reports like they read Sunday newspapers. The information is there if you really want to read it, but most readers pick and choose which information they have time to read.

Annual financial reports are designed for archival purposes, not for a quick read. Instead of addressing the needs of investors and others who want to know about the profit performance and financial condition of the business – but have only a very limited amount of time to do so – accountants produce an annual financial report that is a voluminous financial history of the business. Accountants leave it to the users of annual reports to extract the main points from an annual report. So, financial statement readers use relatively few ratios and other tests to get a feel for the financial performance and position of the business. (Chapters 14 and 17 explain how readers of financial reports get a fix on the financial performance and position of a business.)

Some businesses (and non-profit organisations in reporting to their members and other constituencies) don't furnish an annual financial report. They know that few people have the time or the technical background to read through their annual financial reports. Instead, they provide relatively brief summaries that are boiled-down versions of their official financial statements. Typically these summaries do not provide footnotes or the other disclosures that are included in annual financial reports. These *condensed financial statements*, without footnotes, are provided by several non-profit organisations – credit unions, for instance. If you really want to see the complete financial report of the organisation you can ask its headquarters to send you a copy.

You should keep in mind that annual financial reports do not report everything of interest to owners, creditors and others who have a financial interest in the business. *Annual* reports, of course, come out only once a year – usually two months or so after the end of the company's fiscal (accounting) year. You have to keep abreast of developments during the year by reading financial newspapers or through other means. Also, annual financial reports present the 'sanitised' version of events; they don't divulge scandals or other negative news about the business.

Finally, not everything you may like to know as an investor is included in the annual financial report. For example, for US companies, information about salaries and incentive compensation arrangements with the top-level managers of the business are disclosed in the *proxy statement*, not in the annual financial report of the business. A proxy statement is the means by which the corporation solicits the votes of shareholders on issues that require their approval – one of which is compensation packages of top-level managers. In the US, proxy statements are filed with the SEC and are available on its EDGAR database, www.sec.gov/edgar/searchedgar/cik.htm. In the UK this information would usually appear in the body of the main report under the heading 'Report of the Directors on Remuneration'.

The quality of financial reports varies from company to company. The Investor Relations Society (go to www.irs.org.uk and click on 'IR Best Practice') makes an award each year to the company producing the best (in other words, 'complete' and 'clear') set of reports and accounts.

Part III

Accounting in Managing a Business

After the FIFO method and the LIFO method comes the LILO method.

In this part . . .

Business managers and owners depend on financial statements as well as other internal accounting reports to know how much profit they’re making, where that profit is at the end of the period, and whether the business is in good financial shape or needs improvement. They also use financial statements to keep a close watch on the lifeblood of the business: cash flows. Managers must know how to read their financial statements. Also, they should take advantage of proven accounting tools and techniques to assist them in making profit, controlling cash flow, and keeping the business in good financial condition.

Managers need a good accounting model for analysing profit; they can use budgeting to plan, make projections, and achieve the financial goals of the business, which is the essence of management control. Business managers and owners must decide which ownership structure to use, taking into account risk to personal wealth and the prospects for tax minimisation. Finally, managers should clearly understand how the costs of the business are determined, and they should get involved in choosing the basic accounting methods for measuring profit and for recording values of their assets and liabilities. This often involves making choices that can best be made when managers and accountants are speaking the same language, not always easily achieved as finance is awash with ambiguous terms. This part of the book, in short, explains how accounting helps managers achieve the financial goals of the business and to be better able to communicate effectively with their accountants and finance staff.

Chapter 9

Managing Profit Performance

In This Chapter

- Recasting the profit and loss account to focus on profit factors
- Following two trails to profit
- Breaking even – not the goal, but a useful point of reference
- Doing what-if analysis
- Making trade-offs: Be very careful!

As a manager you get paid to make profit happen. That's what separates you from the non-manager employees at your business. Of course, you have to be a motivator, innovator, consensus builder, lobbyist and maybe sometimes a babysitter too. But the real purpose of your job is to control and improve the profit of your business. No matter how much your staff love you (or do they love those doughnuts you bring in every Monday?), if you don't meet your profit goals, you're facing the unemployment line.

You have to be relentless in your search for better ways to do things. Competition in most industries is fierce, and you can never take profit performance for granted. Changes take place all the time – changes initiated by the business and changes pressured by outside forces. Maybe a new superstore down the street is causing your profit to fall off, and you decide that you'll have a huge sale, complete with splashy ads on TV, to draw customers into the shop.

Slow down, not so fast! First make sure that you can afford to cut prices and spend money on advertising and still turn a profit. Maybe price cuts and splashy ads will keep your cash register singing and the kiddies smiling, but you need to remember that making sales does not guarantee that you make a profit. As all you experienced business managers know, profit is a two-headed beast – profit comes from making sales *and* controlling expenses.

So how do you determine what effect price cuts and advertising costs may have on your bottom line? By turning to your beloved accounting staff, of course, and asking for some *what-if* reports (like ‘What if we offer a 15 per cent discount?’).

This chapter shows you how to identify the key variables that determine what your profit would be if you changed certain factors (such as prices).

Redesigning the External Profit and Loss Account

To begin, Figure 9-1 presents the profit and loss account of a business (the same example as is used in Chapter 8). Figure 9-1 shows an *external profit and loss account* – the profit and loss account that’s reported to the outside investors and creditors of the business. The expenses in Figure 9-1 are presented as they are usually disclosed in an external statement. (Chapter 5 explains sales revenue, expenses and the format of the external profit and loss account.)

Figure 9-1: Example of a business's external profit and loss account.

(Amounts in thousands)

External Profit and Loss Account For Year	
Sales Revenue	£ 52,000
Cost of Goods Sold Expense	31,200
Gross Margin	£ 20,800
Sales, Administration, and General Expenses	15,600
Depreciation Expense	1,650
Earnings Before Interest and Tax	£ 3,550
Interest Expense	750
Earnings Before Tax	£ 2,800
Tax Expense	900
Net Income	£ 1,900

The managers of the business should understand this profit and loss account, of course. But, the external profit and loss account is not entirely adequate for management decision-making; this profit report falls short of providing all the information about expenses needed by managers. But, before moving on to the additional information managers need, take a quick look at the external profit and loss account (Figure 9-1).

REMEMBER

For more information about the external profit and loss account and all its sundry parts, see Chapter 5. Let us just point out the following here about this particular financial statement:

- The business represented by this profit and loss account sells products and therefore has a *cost of goods sold expense.* In contrast, companies that sell services (airlines, cinemas, consultants and so on) don't have a cost of goods sold expense, as all their sales revenue goes toward meeting operating expenses and then providing profit.

- The external profit and loss account shown in Figure 9-1 is prepared according to authorised accounting methods and disclosure standards, but keep in mind that these financial reporting standards are designed for reporting information *outside* the business. Once a profit and loss account is released to people outside the business, a business has no control over the circulation of its statement. The accounting profession, in deciding on the information for disclosure in external profit and loss accounts, has attempted to strike a balance. On the one side are the needs of those who have invested capital in the business and have loaned money to the business; clearly they have the right to receive enough information to evaluate their investments in the business and their loans to the business. On the other side is the need of the business to keep certain information confidential and out of the hands of its competitors. What it comes down to is that certain information that outside investors and creditors might find interesting and helpful does not, in fact, legally have to be disclosed.

- The profit and loss account does not report the *financial effects* of the company's profit-making activities – that is, the increases and decreases in its assets and liabilities caused by revenue and expenses. Managers need to control these financial effects for which purpose they need the complete financial picture provided by the two other primary financial statements (the balance sheet and the cash flow statement) in addition to the profit and loss account. See Chapters 6 and 7 for more about these two other primary financial statements.

Basic Model for Management Profit and Loss Account

Figure 9-2 presents a model for a *management* profit and loss account using the same business as the example whose external profit and loss account is shown in Figure 9-1. Many lines of information are exactly the same – sales revenue and cost of goods sold expense for instance – and thus gross margins are the same. The last five lines in the two statements are the same, starting with operating profit (earnings before interest and corporation tax) down to the bottom line. In other respects, however, there are critical differences between the two profit reports.

Figure 9-2: Mana-gement profit and loss account model.

Management Profit and Loss Account For Year

(Amounts in thousands)	Totals for Period	Per Unit
Unit Sales Volume =	520,000	
Sales Revenue	£52,000	£100
Cost of Goods Sold Expense	31,200	60
Gross Margin	£20,800	£40
Revenue-driven Operating Expenses	4,160	8
Contribution Margin	£16,640	£32
Fixed Operating Expenses	13,090	
Operating Profit, or Earnings Before Interest and Tax Expenses (EBIT)	£ 3,550	
Interest Expense	750	
Earnings Before Tax	£ 2,800	
Tax Expense	900	
Net Income	£ 1,900	

First, note that total *unit sales volume* and *per unit amounts* are included in the management profit and loss account (Figure 9-2). The business appears to sell only one product; the 520,000 units total sales volume is from sales of this product. In fact, most businesses sell a mix of many different products. The company’s various managers need detailed sales revenue and cost information for each product, or product line, or segment of the business they are responsible for. To keep the illustration easy to follow we have collapsed the business’s entire sales into one ‘average’ product. Instead of grappling with 100 or 1,000 different products, we condensed them all into one proxy product. The main purpose of Figure 9-2 is to show a basic template, or model, that can be used for the more detailed reports to different managers in the business organisation.

Variable versus fixed operating expenses

Another fundamental difference between the external profit report (Figure 9-1) and the internal profit report (Figure 9-2) is that the company’s *operating expenses* (sales, administration and general expenses plus depreciation expense) are separated into two different categories in the management report:

- **Variable expenses:** The *revenue-driven expenses* that depend directly on the total sales revenue amount for the period. These expenses move in step with changes in total sales revenue. Commissions paid to salespersons based on a percentage of the amount of sales are a common example of variable operating expenses.
- **Fixed expenses:** The operating expenses that are relatively fixed in amount for the period, regardless of whether the company’s total unit sales (sales volume) had been substantially more, or substantially less, than the 520,000 units that it actually sold during the year. An example of a fixed operating expense is the annual business rates on the company’s property. Also, depreciation is a fixed expense; a certain amount of

depreciation expense is recorded to the year regardless of actual sales volume.

The management profit and loss account does not, we repeat *not*, present different profit numbers for the year compared with the profit numbers reported in the company's external profit and loss account. Note that operating profit for the year (or earnings before interest and tax expenses) is the same as reported outside the business – in Figures 9–1 and 9–2 this number is the same. And in reading down the rest of the two profit and loss accounts, note that earnings before tax and bottom-line net income are the same in both the external and internal reports. The external profit and loss account of the business reports a broad, all-inclusive group of 'Sales, Administration and General Expenses', and a separate expense for depreciation. In contrast, the management profit and loss account reveals information about *how the operating expenses behave relative to the sales of the business*. The actual reporting of expenses in external profit and loss accounts varies from business to business – but you never see profit and loss accounts in which operating expenses are sorted between variable and fixed.

Virtually every business has *variable operating expenses*, which move up and down in tight proportion to changes in unit sales volume or sales revenue. Here are some examples of common variable operating expenses:

- Cost of goods sold expense – the cost of the products sold to customers.
- Commissions paid to salespeople based on their sales.
- Transportation costs of delivering products to customers.
- Fees that a business pays to a bank when a customer uses a credit card such as Visa, MasterCard or American Express.

The management profit and loss account (Figure 9-2) can be referred to as the *internal profit report*, since it is for management eyes only and does not circulate outside the business – although it may be the target of industrial intelligence gathering and perhaps even industrial espionage by competitors. Remember that in the external profit and loss account only one lump sum for the category of sales, administrative and general (SA&G) expenses is reported – a category for which some of the expenses are fixed but some are variable. What you need to do is have your accountant carefully examine these expenses to determine which are fixed and which are variable. (Some expenses may have both fixed and variable components, but we don't go into these technical details.)

Further complicating the matter somewhat is the fact that the accountant needs to divide variable expenses between those that vary with sales *volume* (total number of units sold) and those that vary with sales *revenue* (total pounds of sales revenue). The following examples outline this important distinction:

- An example of an expense driven by sales volume is the cost of shipping and packaging. This cost depends strictly on the *number* of units sold and generally is the same regardless of how much the item inside the box costs.
- An example of an expense driven by sales revenue are sales commissions paid to salespersons, which directly depend on the amounts of sales made to customers. Other examples are franchise fees based on total sales revenue of retailers, business premises rental contracts that include a clause that bases monthly rent on sales revenue, and royalties that are paid for the right to use a well-known name or a trademarked logo in selling the company's products and which are based on total sales revenue.

The business represented in Figure 9-2 has just one variable operating expense – an 8 per cent sales commission, resulting in an expense total of £4,160,000 (£52 million sales revenue × 8 per cent). Of course, a real business probably would have many different variable operating expenses, some driven by unit sales volume and some driven by total sales revenue pounds. But the basic idea is the same for all of them and one variable operating expense serves the purpose here. Also, cost of goods sold expense is itself a sales volume driven expense (see Chapter 13 regarding different accounting methods for measuring this expense). The example shown in Figure 9-2 is a bit oversimplified – the business sells only one product and has only one variable operating expense – but the main purpose is to present a general template that can be tailored to fit the particular circumstances of a business.

Fixed operating expenses are the many different costs that a business is obliged to pay and cannot decrease over the short run without major surgery on the human resources and physical facilities of the business. You must distinguish fixed expenses from your variable operating expenses.

As an example of fixed expenses, consider a typical self-service car wash business – you know, the kind where you drive in, put some coins in a box, and use the water spray to clean your car. Almost all the operating costs of this business are fixed: Rent on the land, depreciation of the structure and the equipment and the annual insurance premium cost don't depend on the number of cars passing through the car wash. The only variable expenses are probably the water, soap and electricity.

If you want to decrease fixed expenses significantly, you need to downsize the business (lay off workers, sell off property and so on). When looking at the various ways you have for improving your profit, significantly cutting down on fixed expenses is generally the last-resort option. Refer to 'Improving profit' later in this chapter for the better options.

Better than anyone else, managers know that sales for the year could have been lower or higher. A natural question is, 'What difference in the profit would there have been at the lower or higher level of sales?' If you'd sold 10 per cent fewer total units during the year, what would your net income (bottom-line profit) have been? You might guess that profit would have slipped 10 per cent but that would *not* have been the case. In fact, profit would have slipped by much more than 10 per cent. Are you surprised? Read on for the reasons.

Why wouldn't profit fall the same percentage as sales? The answer is because of the nature of fixed expenses – just because your sales are lower doesn't mean that your expenses are lower. *Fixed expenses* are the costs of doing business that, for all practical purposes, are stuck at a certain amount over the short term. Fixed expenses do not react to changes in the sales level. Here are some examples of fixed expenses:

- Interest on money that the business has borrowed
- Employees' salaries and benefits
- Business Rates
- Fire insurance

A business can downsize its assets and therefore reduce its fixed expenses to fit a lower sales level, but that can be a drastic reaction to what may be a temporary downturn. After deducting cost of goods sold, variable operating expenses and fixed operating expenses, the next line in the management profit and loss account is operating profit, which is also called *earnings before interest and tax* (or *EBIT*). This profit line in the report is a critical juncture that managers need to fully appreciate.

From operating profit (EBIT) to the bottom line

After deducting all operating expenses from sales revenue, you get to earnings before interest and tax (EBIT), which is £3,550,000 in the example. *Operating* is an umbrella term that includes cost of goods sold expense and all other expenses of making sales and operating your business – but not interest and tax. Sometimes EBIT is called *operating profit*, or *operating earnings*, to emphasise that profit comes from making sales and controlling operating expenses. This business earned £3,550,000 operating profit from its £52 million sales revenue – which seems satisfactory. But is its £3,550,000 EBIT really good enough? What's the reference for answering this question?

The main benchmark for judging EBIT is whether this amount of profit is adequate to cover the *cost of capital* of the business. Chapter 6 explains the various assets that a business needs to make sales and earn profit. A business must secure money to invest in its various assets – and this capital has a cost. A business has to pay interest on its debt capital, and it should earn enough after-tax net income (bottom-line profit) to satisfy its owners who have put their capital in the business. See the sidebar 'How much net income is needed to make owners happy?' in this chapter.

Nobody – not even the most die-hard humanitarian – is in business to make a zero EBIT. You simply can't do this, because profit is an absolutely necessary part of doing business – and recouping the cost of capital is why profit is needed.

Don't treat the word *profit* as something that's whispered in the hallways. Profit builds owners' value and provides the basic stability for a business. Earning a satisfactory EBIT is the cornerstone of business. Without earning an adequate operating profit, a business could not attract capital, and you can't have a business without capital.

How much net income is needed to make owners happy?

People who invest in a business usually aren't philanthropists who don't want to make any money on the deal. No, these investors want a business to protect their capital investment, earn a good bottom-line profit for them and enhance the value of their investment over time. They understand that a business may not earn a profit but suffer a loss – that's the risk they take as owners.

As described in Chapters 6 and 11, how much of a business's net income (bottom-line profit) is distributed to the owners depends on the business and the arrangement that it made with the owners. But regardless of how much money the owners actually receive, they still have certain expectations of how well the business will do – that is, what the business's earnings before interest and tax will be. After all, they've staked their money on the business's success.

One test of whether the owners will be satisfied with the net income (after interest and tax) is to compute the *return on equity* (ROE), which is the ratio of net income to total owners' equity (net income ÷ owners' equity). In this chapter's business example, the bottom-line profit is £1.9 million. Suppose that the total owners' equity in the business is £15.9 million (as shown in Figure 8–1 for the business example). Thus, the ROE is 12 per cent (£1.9 million ÷ £15.9 million). Is 12 per cent a good ROE? Well, that depends on how much the owners could earn from an alternative investment. We'd say that a 12 per cent ROE isn't bad. By the way, ROE is also known as ROSI: *return on shareholders' investment*.

Note: ROE does not imply that all the net income was distributed in cash to the owners. Usually, a business needs to retain a good part of its bottom-line net income to provide capital for growing the business. Suppose, in this example, that none of the net income is distributed in cash to its owners. The ROE is still 12 per cent; ROE does not depend on how much, if any, of the net income is distributed to the owners. (Of course, the owners may prefer that a good part of the net income be distributed to them.)

Travelling Two Trails to Profit

How is the additional information in the management profit and loss account useful? Well, with this information you can figure out how the business earned its profit for the year. We're not referring to how the company decided which products to sell, and the best ways to market and advertise its products, and how to set sales prices, and how to design an efficient and smooth running organisation, and how to motivate its employees, and all the other things every business has to do to achieve its financial goals. We're talking about an *accounting explanation of profit* that focuses on methods for calculating profit – going from the basic input factors of sales price, sales volume and costs to arrive at the amount of profit that results from the interaction of the factors. Business managers should be familiar with these accounting calculations. They are responsible for each factor and for profit, of course. With this in mind, therefore: How did the business earn its profit for the year?

First path to profit: Contribution margin minus fixed expenses

We can't read your mind. But, if we had to hazard a guess regarding how you would go about answering the profit question, we'd bet that, after you had the chance to study

Figure 9-2, you would do something like the following, which is correct as a matter of fact:

Computing Profit Before Tax

Contribution margin per unit	£32
× Unit sales volume	520,000
Equals: Total contribution margin	£16,640,000
Less: Total fixed operating expenses	£13,090,000
Equals: Operating profit (EBIT)	£3,550,000
Less: Interest Expense	£750,000
Equals: Earnings before tax	£2,800,000

Note that we stop at the *earnings before tax* line in this calculation. You're aware, of course, that business profit is subject to tax. Chapter 3 provides a general overview of the taxation of business profit. This chapter focuses on profit above the taxation expense line. Nevertheless, please keep in mind as a broad rule of thumb that taxable income of a regular business corporation is subject to around 30 per cent tax in addition to value added – except small businesses whose taxable income is taxed at a lower rate.

Contribution margin is what's left over after you subtract cost of goods sold expense and other variable expenses from sales revenue. On a *per unit* basis the business sells its product for £100, its variable product cost (cost of goods sold) is £60 and its variable operating cost per unit is £8 – which yields £32 contribution margin per unit. *Total* contribution margin for a period equals contribution margin per unit times the units sold during the period – in the business example, £32 × 520,000 units, which is £16,640,000 total contribution margin. Total contribution margin is a measure of profit *before fixed expenses are deducted*. To pay for its fixed operating expenses and its interest expense, a business needs to earn a sufficient amount of total contribution margin. In the example, the business earned more total contribution margin than its fixed expenses, so it earned a profit for the year.

How variable expenses mow down your sales price

Consider a retail hardware store that sells, say, a lawnmower to a customer. The purchase cost per unit that the retailer paid to the lawnmower manufacturer when the retailer bought its shipment is the *product cost* in the contribution margin equation. The retailer also provides one free servicing of the lawnmower after the customer has used it a few months (cleaning it and sharpening the blade) and also pays its salesperson a commission on the sale. These two additional expenses, for the service and the commission, are examples of variable expenses in the margin equation.

Here are some other concepts associated with the term *margin*, which you're likely to encounter:

- **Gross margin, also called gross profit:** Gross margin = sales revenue – cost of goods sold expense. Gross margin is profit from sales revenue *before* deducting the other variable expenses of making the sales. So gross margin is one step short of the final contribution margin earned on making sales. Businesses that sell products must report gross margin on their *external* profit and loss accounts. However, generally accounting standards do *not* require that you report other variable expenses of making sales on external profit and loss accounts. In their external financial reports, very few businesses divulge other variable expenses of making sales. In other words, managers do not want the outside world and competitors to know their contribution margins. Most businesses carefully guard information about contribution margins because the information is very sensitive.

- **Gross margin ratio:** Gross margin ratio = gross margin ÷ sales revenue. In the business we use as an example in this chapter, the gross margin on sales is 40 per cent. Gross margins of companies vary from industry to industry, from over 50 per cent to under 25 per cent – but very few businesses can make a bottom-line profit with less than a 20 per cent gross margin.

- **Markup:** Generally refers to the amount added to the product cost to determine the sales price. For example, suppose a product that cost £60 is marked up (based on cost) by 66⅔ per cent to determine its sales price of £100 – for a gross margin of £40 on the product. ***Note:*** The markup based on *cost* is 66⅔ per cent (£40 markup ÷ £60 product cost). But the gross margin ratio is only 40 per cent, which is based on *sales price* (£40 ÷ £100).

Second path to profit: Excess over break-even volume × contribution

margin per unit

The second method of computing a company's profit starts with a particular sales volume as the point of reference. So, the first step is to compute this specific sales volume of the business (which is not its actual sales volume for the year) by dividing its total annual fixed expenses by its contribution margin per unit. Interest expense is treated as a fixed expense (because for all practical purposes it is more or less fixed in amount over the short-run). For the business in the example, the interest expense is $750,000 (see Figure 9–2), which, added to the $13,090,000 fixed operating expenses, gives total fixed expenses of $13,840,000. The company's *break-even point*, also called its *break-even sales volume*, is computed as follows:

$13,840,000 total annual fixed expenses for year ÷ $32 contribution margin per unit = 432,500 units break-even point (or, break-even sales volume) for the year

In other words, if you multiply $32 contribution margin per unit by 432,500 units you get a total contribution margin of $13,840,000, which exactly equals the company's total fixed expenses for the year. The business actually sold more than this number of units during the year but, if it had sold only 432,500 units, the company's profit would have been exactly zero. Below this sales level the business suffers a loss, and above this sales level the business makes profit. The break-even sales volume is the crossover point from the loss column to the profit column. Of course, a business's goal is to do better than just reaching its break-even sales volume.

Calculating its break-even point calls attention to the amount of fixed expenses hanging over a business. As explained earlier, a business is committed to its fixed expenses over the short run and cannot do much to avoid these costs – short of breaking some of its contracts and taking actions to downsize the business that could have disastrous long-run effects. Sometimes the total fixed expenses for the year are referred to as the 'nut' of the business – which may be a hard nut to crack (by exceeding its break-even sales volume).

In the example (see Figure 9–2) the business actually sold 520,000 units during the year, which is 87,500 units more than its break-even sales volume (520,000 units sold minus its 432,500 break-even sales volume). Therefore, you can determine the company's earnings before tax as follows:

Second Way of Computing Profit

Contribution margin per unit	£32
× Units sold in excess of break-even point	87,500
Equals: Earnings before tax	£2,800,000

This second way of analysing profit calls attention to the need of the business to achieve and exceed its break-even point to make profit. The business makes no profit until it clears its break-even hurdle, but once over this level of sales it makes profit hand over fist because the units sold from here on are not burdened with any fixed costs, which have been covered by the first 432,500 units sold during the year. Be careful in thinking that only the last 87,500 units sold during the year generate all the profit for the year. The first 432,500 units sold are necessary to get the business into position in order for the next 87,500 units to make profit.

The key point is that once the business has reached its break-even sales volume (thereby covering its annual fixed expenses), each additional unit sold brings in pre-tax profit equal to the contribution margin per unit. Each additional unit sold brings in 'pure profit' of £32 per unit, which is the company's contribution margin per unit. A business has to get into this upper region of sales volume to make a profit for the year.

Calculating the margin of safety

The *margin of safety* is the excess of its actual sales volume over a company's break-even sales volume. This business sold 520,000 units, which is 87,500 units above its break-even sales volume – a rather large cushion against any downturn in sales. Only a major sales collapse would cause the business to fall all the way down to its break-even point, assuming that it can maintain its £32 contribution margin per unit and that its fixed costs don't change. You may wonder what a 'normal' margin of safety is for most businesses. Sorry, we can't give you a definitive answer on this. Due to the nature of the business or industry-wide problems, or due to conditions beyond its control, a business may have to operate with a smaller margin of safety than it would like.

Doing What-If Analysis

Managing profit is like driving a car – you need to be glancing in the rear-view mirror constantly as well as looking ahead through the windscreen. You have to know your profit history to see your profit future. Understanding the past is the best preparation for the future.

The model of a *management profit and loss account* shown in Figure 9-2 allows you to compare your actual profit with what it would've looked like if you'd done something differently – for example, raised prices and sold fewer units. With the profit model, you can test-drive adjustments before putting them into effect. It lets you plan and map out your profit strategy for the *coming* period. Also, you can analyse why profit went up or down from the *last* period, using the model to do hindsight analysis.

TIP

The management profit and loss account profit model focuses on the key factors and variables that drive profit. Here's what you should know about these factors:

- Even a small decrease in the contribution margin per unit can have a drastic impact on profit because fixed expenses don't go down over the short run (and may be hard to reduce even over the long run).
- Even a small increase in the contribution margin per unit can have a dramatic impact on profit because fixed expenses won't go up over the short run – although they may have to be increased in the long run.
- Compared with changes in contribution margin per unit, sales volume changes have secondary profit impact; sales volume changes are not trivial, but even relatively small margin changes can have a bigger effect on profit.
- You can, perhaps, reduce fixed expenses to improve profit, but you have to be very careful to cut fat and not muscle; reducing fixed expenses may very well diminish the capacity of your business to make sales and deliver a high-quality service to customers.

The following sections expand on these key points.

Lower profit from lower sales – but that much lower?

The management profit and loss account shown in Figure 9-2 is designed for managers to use in profit analysis – to expose the critical factors that drive profit. Remember what information has been added that isn't included in the external profit and loss account:

- **Unit sales volume** for the year
- **Per-unit values**
- **Fixed versus variable** operating expenses
- **Contribution margin** – total and per unit

Handle this information with care. The contribution margin per unit is confidential, for your eyes only. This information is limited to you and other managers in the business. Clearly, you don't want your competitors to find out your margins. Even within a business, the information may not circulate to all managers – just those who need to know.

The contribution margin per unit is one of the three most important determinants of profit performance, along with sales volume and fixed expenses – as shown in the upcoming sections.

With the information provided in the management profit and loss account, you're ready to paint a what-if scenario. We're making you the chief executive officer of the business in this example. What if you had sold 5 per cent fewer units during this period? In this example, that would mean you had sold only 494,000 units rather than 520,000 units, or 26,000 units less. The following computation shows you how much profit damage this seemingly modest drop in sales volume would've caused.

Impact of 5% Lower Sales Volume on Profit

Contribution margin per unit	£32
× 26,000 fewer units sold	26,000
Equals: Decrease in earnings before tax	£832,000

By selling 26,000 fewer units you missed out on the £832,000 profit that these units would have produced – this is fairly straightforward. What is not so obvious, however, is that this £832,000 decrease in profit would have been a 30 per cent drop in profit: £832,000 decrease ÷ £2,800,000 profit = 30 per cent decrease. Lose just 5 per cent of your sales and lose 30 per cent of your profit? How can such a thing happen? The next section expands on how a seemingly small decrease in sales volume can cause a stunning decrease in profit. Read on.

Violent profit swings due to operating leverage

First, the bare facts for the business in the example: The company's contribution margin per unit is £32 and, before making any changes, the company sold 520,000 units during the year, which is 87,500 units in excess of its break-even sales volume. The company earned a total contribution margin of £16,640,000 (see Figure 9-2), which is its contribution per unit times its total units sold during the year. If the company had sold 5 per cent less during the year (26,000 fewer units), you'd expect its total contribution margin to decrease 5 per cent, and you'd be absolutely correct – £832,000 decrease ÷ £16,640,000 = 5 per cent decrease. Compared with its £2,800,000 profit before tax, however, the £832,000 drop in total contribution margin equals a *30 per cent* fall-off in profit.

The main focus of business managers and investors is on profit, which in this example is profit before tax. Therefore, the 30 per cent drop in profit would get more attention than the 5 per cent drop in total contribution margin. The much larger percentage change in profit caused by a relatively small change in sales volume is the effect of *operating leverage*. Leverage means that there is a multiplier effect – that a relatively small percentage change in one factor can cause a much larger change in another factor. A small push can cause a large movement – this is the idea of leverage.

In the above scenario for the 5 per cent, 26,000 units decrease in sales volume, note that the 5 per cent is based on the total 520,000 units sales volume of the business. But, if the 26,000 units decrease in sales volume is divided by the 87,500 units in excess of the company's break-even point – which are the units that generate profit for the business – the sales volume decrease equals 30 per cent. In other words, the business lost 30 per cent of its profit layer of sales volume and, thus, the company's profit would have dropped 30 per cent. This dramatic drop is caused by the operating leverage effect.

Note: If the company had sold 5 per cent *more* units, with no increase in its fixed expenses, its pre-tax profit would have *increased* by 30 per cent, reflecting the operating leverage effect. The 26,000 additional units sold at a \$32 contribution margin per unit would increase its total contribution margin by \$832,000 and this increase would increase profit by 30 per cent. You can see why businesses are always trying to increase sales volume.

Cutting sales price, even a little, can gut profit

So, what effect would a 5 per cent decrease in the sales price have caused? Around a 30 per cent drop similar to the effect of a 5 per cent decrease in sales volume? Not quite. Check out the following computation for this 5 per cent sales price decrease scenario:

Impact of 5% Lower Sales Price on Profit

Contribution margin per unit decrease	£4.60
× Units sold during year	520,000
Equals: Decrease in earnings before tax	£2,392,000

Hold on! Earnings before tax would drop from £2,800,000 at the £100 sales price (refer to Figure 9–2) to only £408,000 at the £95 sales price – a plunge of 85 per cent. What could cause such a drastic dive in profit?

The sales price drops £5 per unit – a 5 per cent decrease of the £100 sales price. But, contribution margin per unit does not drop by the entire £5 because the variable operating expense per unit (sales commissions in this example) would also drop 5 per cent, or £40 per unit – for a net decrease of £4.60 per unit in the contribution margin per unit. (This is one reason for identifying the expenses that depend on sales revenue – as shown in the management profit and loss account in Figure 9-2.) For this what-if scenario that examines the case of the company selling all units at a 5 per cent lower sales price than it did, the company's contribution margin would have been only £27.40 per unit. Such a serious reduction in its contribution margin per unit would have been intolerable.

At the lower sales price, the company's contribution margin would be £27.40 per unit (£32.00 in the original example minus the £4.60 decrease = £27.40). As a result, the break-even sales volume would be much higher, and the company's 520,000 sales volume for the year would have been only 14,891 units over its break-even point. So, the lower £27.40 contribution margin per unit would yield only £408,000 profit before tax.

The moral of the story is to protect contribution margin per unit above all else. Every pound of contribution margin per unit that's lost – due to decreased sales prices, increased product cost or increases in other variable costs – has a tremendously negative impact on profit. Conversely, if you can increase the contribution margin per unit without hurting sales volume, you reap very large profit benefits, as described next.

Improving profit

The preceding sections explore the downside of things – that is, what would've happened to profit if sales volume or sales prices had been lower. The upside – higher profit – is so much more pleasant to discuss and analyse, don't you think?

Profit improvement boils down to the three critical profit-making factors, listed in order from the most effective to the least effective:

- Increasing the contribution margin per unit
- Increasing sales volume
- Reducing fixed expenses

Say you want to improve your bottom-line profit from the £1,900,000 net income you earned the year just ended to £2,110,000 next year. How can you pump up your net income by £210,000? (By the way, this is the only place in the chapter we bring the tax factor into the analysis.)

First of all, realise that to increase your net income *after taxes* by £210,000, you need to increase your before-tax profit by much more – to provide for the amount that goes to tax. Your accountant calculates that you would need a £312,000 increase in earnings before tax next year because your tax increase would be about £102,000 on the £312,000 increase in pre-tax earnings. So, you have to find a way to increase earnings, before tax, by £312,000.

You should also take into account the possibility that fixed costs and interest expense may rise next year, but for this example we're assuming that they won't. We're also assuming that the business can't cut any of its fixed operating expenses without hurting its ability to maintain and support its present sales level (and a modest increase in the sales level). Of course, in real life, every business should carefully scrutinise its fixed expenses to see if some of them can be cut.

- Increase your contribution margin per unit by £0.60, which would raise the total contribution margin by

£312,000, based on a 520,000 units sales volume (£0.60 × 520,000 = £312,000).

- Sell 9,750 additional units at the current contribution margin per unit of £32, which would raise the total contribution margin by £312,000 (9,750 × £32 = £312,000).
- Use a combination of these two approaches: Increase both the margin per unit and the sales volume.

The second approach is obvious – you just need to set a sales goal of increasing the number of products sold by 9,750 units. (How you motivate your already overworked sales staff to accomplish that sales volume goal is up to you.) But how do you go about the first approach, increasing the contribution margin per unit by £0.60?

The simplest way to increase contribution margin per unit by £0.60 would be to decrease your product cost per unit by £0.60. Or you could attempt to reduce sales commissions from £8 per £100 of sales to £7.40 per £100 – which may adversely affect the motivation of your sales force, of course. Or you could raise the sales price about £0.65 (remember that 8 per cent comes off the top for the sales commission, so only £0.60 would remain from that £0.65 to improve the unit contribution margin). Or you could combine two or more such changes so that your unit contribution next year would increase £0.60. However you do it, the improvement would increase your earnings before tax the desired amount:

Impact of £0.60 Higher Unit Contribution Margin on Profit

Contribution margin per unit increase	£0.60
× Units sold during year	520,000
Equals: Increase in earnings before tax	£312,000

Cutting prices to increase sales volume: A very tricky game to play!

A word of warning: Be sure to *run the numbers* (accountant speak for using a profit model) before deciding to drop sales prices in an effort to gain more sales volume. Suppose, for example, you're convinced that if you decrease sales prices by 5 per cent your sales volume will increase by 10 per cent. Seems like an attractive trade-off, one that would increase both profit performance and market share. But are you sure that those positive changes are the results you'll get?

The impact on profit may surprise you. Get a piece of notepaper and do the computation for this lower sales price and higher sales volume scenario:

Lower Sales Price and Higher Sales Volume Impact on Profit

New sales price (lower)	£95.00
Less: Product cost per unit (same)	£60.00
Less: Variable operating expenses (lower)	£7.60
Equals: New unit contribution margin (lower)	£27.40
× Sales volume (higher)	572,000
Equals: Total contribution margin	£15,672,800
Less: Previous total contribution margin	£16,640,000
Equals: Decrease in total contribution margin	£967,200

Your total contribution margin would not go up; instead, it would go down £967,200! In dropping the sales price by £5, you would give up too much of your contribution margin per unit. The increase in sales volume would not make up for the big dent in unit contribution margin. You may gain more market share, but would pay for it with a £967,200 drop in earnings before tax.

To keep profit the same, you would have to increase sales volume more than 10 per cent. By how much? Divide the total contribution margin for the 520,000 units situation by the contribution margin per unit for the new scenario:

£16,640,000 ÷ £27.40 = 607,300 units

In other words, just to keep your total contribution margin the same at the lower sales price, you would have to increase sales volume to 607,300 units – an increase of 87,300 units, or a whopping 17 per cent. That would be quite a challenge, to say the least.

Cash flow from improving profit margin versus improving sales volume

This chapter discusses increasing profit margin versus increasing sales volume to improve bottom-line profit. Improving your profit margin is the better way to go, compared with increasing sales volume. Both actions increase profit, but the profit margin tactic is much better in terms of cash flow. When sales volume increases, so does stock. On the other hand, when you improve profit margin (by raising the sales price or by lowering product cost), you don’t have to increase stock – in fact, reducing product cost may actually cause stock to decrease a little. In short, increasing your profit margin yields a higher cash flow from profit than does increasing your sales volume.

The SCORE website offers a downloadable Excel spreadsheet that enables you to do as many ‘what if’ calculations as you like (go to www.score.org, register and click on Templates and Tools). You can push your selling price up and down, add in and strip out costs, and see what your break-even point will be. By adding in your target profit as a ‘fixed cost’ at the last line where you’re asked for the ‘Owner’s Draw’ (in other words, what money the shareholder(s) expects), you can work out break-even volumes to meet those profit goals. You can shortcut the route to this spreadsheet by going on Microsoft’s template site (http://office.microsoft.com/en-us/templates/break-even-analysis-TC001017515.aspx).

A Final Word or Two

Recently, some friends pooled their capital and opened an up-market off-licence in a rapidly growing area. The business has a lot of promise. We can tell you one thing they should have done before going ahead with this new venture – in addition to location analysis and competition analysis, of course. They should have used the basic profit model (in other words, the management profit and loss account) discussed in this chapter to figure out their break-even sales volume – because we're sure they have rather large fixed expenses. And they should have determined how much more sales revenue over their break-even point that they will need to earn a satisfactory return on their investment in the business.

During their open house for the new shop we noticed the very large number of different beers, wines and spirits available for sale – to say nothing of the different sizes and types of containers many products come in. Quite literally, the business sells thousands of distinct products. The shop also sells many products like soft drinks, ice, corkscrews and so on. Therefore, the company does not have a single sales volume factor (meaning the number of units sold) to work with in the basic profit model. So, you have to adapt the profit model to get along without the sales volume factor.

The trick is to determine your *average contribution margin as a percentage of sales revenue*. We'd estimate that an off-licence's average gross margin (sales revenue less cost of goods sold) is about 25 per cent. The other variable operating expenses of the shop probably run about 5 per cent of sales. So, the average contribution margin would be 20 per cent of sales (25 per cent gross margin less 5 per cent variable operating expenses). Suppose the total fixed operating expenses of the shop are about £100,000 per month (for rent, salaries, electricity and so on), which is £1.2 million per year. So, the shop needs £6 million in sales per year just to break even:

£1.2 million fixed expenses ÷ 20% average contribution margin = £6 million annual sales to break even

Selling £6 million of product a year means moving a lot of booze. The business needs to sell another £1 million to provide £200,000 of operating earnings (at the 20 per cent average contribution margin) – to pay interest expense, tax and to leave enough net income for the owners who invested capital in the business and who expect a good return on their investment.

JARGON ALERT

By the way, some disreputable off-licence owners are known (especially to HM Revenue and Customs) to engage in *sales skimming*. This term refers to not recording all sales revenue; instead, some cash collected from customers is put in the pockets of the owners. They don't report the profit in their tax returns or in the profit and loss accounts of the business. Our friends who started the off-licence are honest business people, and we're sure they won't engage in sales skimming – but they do have to make sure that none of their store's employees skim off some sales revenue.

When sales skimming is being committed, not all of the actual sales revenue for the year is recorded, even though the total cost of all products sold during the year is recorded. Obviously, this distorts the profit and loss account and throws off normal ratios of gross profit and operating profit to sales revenue. If you have the opportunity to buy a business, please be alert to the possibility that some sales skimming may have been done by the present owner. Indeed, we've been involved in situations in which the person selling the business bragged about how much he was skimming off the top.

Chapter 10

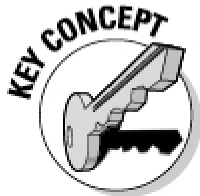
Business Budgeting

In This Chapter

- Discovering the benefits of budgeting
- Designing accounting reports for managers
- Budgeting in action: developing a profit plan and projecting cash flow from profit
- Investing for the long haul
- Staying flexible with budgets

A business can't open its doors each day without having some idea of what to expect. And it can't close its doors at the end of the day not knowing what happened. In the Boy Scouts, the motto is 'Be Prepared'. Likewise, a business should plan and be prepared for its future, and should control its actual performance to reach its financial goals. The only question is how.

Budgeting is one answer. Please be careful with this term. Budgeting does *not* refer to putting a financial straitjacket on a business. Instead, business budgeting refers to setting specific goals and having the detailed plans necessary to achieve the goals. Business budgeting is built on realistic forecasts for the coming period, and demands that managers develop a thorough understanding of the profit blueprint of the business as well as the financial effects of the business's profit-making activities. A business budget is an integrated plan of action – not simply a few trend lines on a financial chart. Business managers have two broad options – they can wait for results to be reported to them on a 'look back' basis, or they can look ahead and plan what profit and cash flow should be, and then compare actual results against the plan. Budgeting is the method used to enact this second option.



The financial statements included in the annual financial report of a business are prepared *after the fact*; that is, the statements are based on actual transactions that have already taken place. Budgeted financial statements, on the other hand, are prepared *before the fact*, and are based on future transactions that you expect to take place based on the business's profit and financial strategy and goals. These forward-looking financial statements are referred to as *pro forma*, which is Latin for 'provided in advance'. ***Note:*** Budgeted financial statements are not reported outside the business; they are strictly for internal management use.

You can see a business's budget most easily in its set of *budgeted financial statements* – its budgeted profit and loss account, balance sheet and cash flow statement. Preparing these three budgeted financial statements requires a lot of time and effort; managers do detailed analysis to determine how to improve the financial performance of the business. The vigilance required in budgeting helps to maintain and improve profit performance and to plan cash flow.

Budgeting is much more than slap-dashing together a few figures. A budget is an integrated financial plan put down on paper, or these days we should say entered in computer spreadsheets. Planning is the key characteristic of budgeting. The budgeted financial statements encapsulate the financial plan of the business for the coming year.

The Reasons for Budgeting

Managers don't just look out the window and come up with budget numbers. Budgeting is not pie-in-the-sky wishful thinking. Business budgeting – to have real value – must start with a critical analysis of the most recent actual performance and position of the business by the managers who are responsible for the results. Then the managers decide on specific and concrete goals for the coming year. Budgets can be done for more than one year, but the key stepping-stone into the future is the budget for the coming year – see the sidebar 'Taking it one game at a time'.

In short, budgeting demands a fair amount of management time and energy. Budgets have to be worth this time and effort. So why should a business go to the trouble of budgeting? Business managers do budgeting and prepare budgeted financial statements for three quite different reasons – distinguishing them from each other is useful.

The modelling reasons for budgeting

To construct budgeted financial statements, you need good models of the profit, cash flow and financial condition of your business. Models are blueprints, or schematics of how things work. A business budget is, at its core, a financial blueprint of the business.

Taking it one game at a time

A company generally prepares one-year budgets, although many businesses also develop budgets for two, three and five years. However, reaching out beyond a year becomes quite tentative and very iffy. Making forecasts and estimates for the next 12 months is tough enough. A one-year budget is much more definite and detailed in comparison to longer-term budgets. As they say in the sports world, a business should take it one game (or year) at a time.

Looking down the road beyond one year is a good idea, to set long-term goals and to develop long-term strategy. But long-term planning is different than long-term budgeting.

Note: Don’t be intimidated by the term model. It simply refers to an explicit, condensed description of how profit, cash flow, and assets and liabilities behave. For example, Chapter 9 presents a model of a management profit and loss account. A model is analytical, but not all models are mathematical. In fact, none of the financial models in this book is the least bit mathematical – but you do have to look at each factor of the model and how it interacts with one or more other factors. The simple accounting equation, assets = liabilities + owners’ equity, is a model of the balance sheet, for example. And, as Chapter 9 explains, profit = contribution margin per unit × units sold in excess of the break-even point.

Budgeting relies on financial models, or blueprints, that serve as the foundation for each budgeted financial statement. These blueprints are briefly explained, as follows:

- **Budgeted management profit and loss account:** Chapter 9 presents a design for the internal profit and loss account that provides the basic information that managers need for making decisions and exercising control. This internal (for managers only) profit report contains information that is not divulged outside the business. The management profit and loss account shown in Figure 9-2 serves as a hands-on profit model – one that highlights the critical variables that drive profit. This management profit and loss account separates variable and fixed expenses and includes sales volume, contribution margin per unit, as well as other factors that determine profit performance. The management profit and loss account is like a schematic that shows the path to the bottom line. It reveals the factors that must be improved in order to improve profit performance in the coming period.

- **Budgeted balance sheet:** The key connections and ratios between sales revenue and expenses and their related assets and liabilities are the elements of the basic model for the budgeted balance sheet. These vital connections are explained throughout Chapters 5 and 6; Chapter 8 (specifically Figure 8–1) also presents an overview of these connections.
- **Budgeted cash flow statement:** The changes in assets and liabilities from their balances at the end of the year just concluded and the balances at the end of the coming year determine cash flow from profit for the coming year. These changes constitute the basic model of cash flow from profit, which Chapter 7 explains (see Figure 7-3 in particular). The other sources and uses of cash depend on managers' strategic decisions regarding capital expenditures that will be made during the coming year, and how much new capital will be raised by increased debt and from owners' additional investment of capital in the business.

REMEMBER

In short, budgeting requires good working models of profit performance, financial condition (assets and liabilities), and cash flow from profit. Constructing good budgets is a strong incentive for businesses to develop financial models that not only help in the budgeting process but also help managers make day-to-day decisions.

Planning reasons for budgeting

One main purpose of budgeting is to develop a definite and detailed financial plan for the coming period. To do budgeting, managers have to establish explicit financial objectives for the coming year and identify exactly what has to be done to accomplish these financial objectives. Budgeted financial statements and their supporting schedules provide clear destination points – the financial flight plan for a business.

The process of putting together a budget directs attention to the specific things that you must do to achieve your profit objectives and to optimise your assets and capital requirements. Basically, budgets are a form of planning, and planning pushes managers to answer the question 'How are we going to get there from here?'

Budgeting also has other planning-related benefits:

- **Budgeting encourages a business to articulate its vision, strategy and goals.** A business needs a clearly-stated strategy guided by an over- arching vision, and should have definite and explicit goals. It is not enough for business managers to have strategy and goals in their heads – and nowhere else. Developing budgeted financial statements forces managers to be explicit and definite about the objectives of the business, and to formulate realistic plans for achieving the business objectives.
- **Budgeting imposes discipline and deadlines on the planning process.** Many busy managers have trouble finding enough time for lunch, let alone planning for the upcoming financial period. Budgeting pushes managers to set aside time to prepare a detailed plan that serves as a road map for the business. Good planning results in

a concrete course of action that details how a company plans to achieve its financial objectives.

Management control reasons for budgeting

Budgets can be and usually are used as a means of *management control*, which involves comparing budgets against actual performance and holding individual managers responsible for keeping the business on schedule in reaching its financial objectives. The board of directors of a corporation focus their attention on the master budget for the whole business: the budgeted management profit and loss account, the budgeted balance sheet and the budgeted cash flow statement for the coming year.

The chief executive officer and the chairman of the business focus on the master budget. They also look at how each manager in the organisation is doing on his or her part of the master budget. As you move down the organisation chart of a business, managers have narrower responsibilities – say, for the business's north-eastern territory or for one major product line – therefore, the master budget is broken down into parts that follow the business's organisational structure. In other words, the master budget is put together from many pieces, one for each separate organisational unit of the business. So, for example, the manager of one of the company's far-flung warehouses has a separate budget for expenses and stock levels for his or her area.

By using budget targets as benchmarks against which actual performance is compared, managers can closely monitor progress toward (or deviations from) the budget goals and timetable. You use a budget plan like a navigation chart to keep your business on course. Significant variations from budget raise red flags, in which case you can determine that performance is off course or that the budget needs to be revised because of unexpected developments.

For management control, the annual budgeted management profit and loss account is divided into months or quarters. The budgeted balance sheet and budgeted cash flow statement are also put on a monthly or quarterly basis. The business should not wait too long to compare budgeted sales revenue and expenses against actual performance (or to compare actual cash flows and asset levels against the budget timetable). You need to take prompt action when problems arise, such as a divergence between budgeted expenses and actual expenses. Profit is the main thing to pay attention to, but debtors and stock can get out of control (become too high relative to actual sales revenue and cost of goods sold expense), causing cash flow problems. (Chapter 7 explains how increases in debtors and stock are negative factors on cash flow from profit.) A business cannot afford to ignore its balance sheet and cash flow numbers until the end of the year.

Other benefits of budgeting

Budgeting has advantages and ramifications that go beyond the financial dimension and have more to do with business management in general. These points are briefly discussed as follows:

- **Budgeting forces managers to do better forecasting.** Managers should constantly scan the business environment to identify sea changes that can impact the business. Vague generalisations about what the future might hold for the business are not quite good enough for assembling a budget. Managers are forced to put their predictions into definite and concrete forecasts.
- **Budgeting motivates managers and employees by providing useful yardsticks for evaluating performance and for setting managers' compensation when goals are achieved.** The budgeting process can have a good motivational impact on employees and managers by involving managers in the budgeting process (especially in setting goals and objectives) and by providing incentives to managers to strive for and achieve the business's goals and objectives. Budgets can be used to reward good results. Budgets provide useful information for superiors to evaluate the performance of managers. Budgets supply baseline financial information for incentive compensation plans. The profit plan (budget) for the year can be used to award year-end bonuses according to whether designated goals are achieved.
- **Budgeting is essential in writing a business plan.** New and emerging businesses must present a convincing *business plan* when raising capital. Because these businesses may have little or no history, the managers and owners of a small business must demonstrate convincingly that the company has a clear strategy and a realistic plan to make money. A coherent, realistic budget forecast is an essential component of a business plan. Venture capital sources definitely want to see the budgeted financial statements of the business.

In larger businesses, budgets are typically used to hold managers accountable for their areas of responsibility in the organisation; actual results are compared against budgeted goals and timetables, and variances are highlighted. Managers don't mind taking credit for *favourable* variances, or when actual comes in better than budget. Beating the budget for the period, after all, calls attention to outstanding performance. But *unfavourable* variances are a different matter. If the manager's budgeted goals and targets are fair and reasonable, the manager should carefully analyse what went wrong and what needs to be improved. But if the manager perceives the budgeted goals and targets to be arbitrarily imposed by superiors and not realistic, serious motivational problems can arise.

In reviewing the performance of their subordinates, managers should handle unfavourable variances very carefully. Stern action may be called for, but managers should recognise that the budget benchmarks may not be entirely fair, and should make allowances for unexpected developments that occur after the budget goals and targets are established.

Budgeting and Management Accounting

What we say earlier in the chapter can be likened to an advertisement for budgeting – emphasising the reasons for and advantages of budgeting by a business. So every business does budgeting, right? Nope. Smaller businesses generally do little or no budgeting – even many larger businesses avoid budgeting. The reasons are many, and mostly practical in nature.

Some businesses are in relatively mature stages of their life cycle or operate in an industry that is mature and stable. These companies do not have to plan for any major changes or discontinuities. Next year will be a great deal like last year. The benefits of going through a formal budgeting process do not seem worth the time and cost to them. At the other extreme, a business may be in a very uncertain environment; attempting to predict the future seems pointless. A business may lack the expertise and experience to prepare budgeted financial statements, and it may not be willing to pay the cost for an accountant or outside consultant to help.

In applying for a loan, the lender may be impressed that your business plan includes a well-thought-out budget. I (John) served on a local bank's board of directors for several years, and I reviewed many loan requests. Our bank did not expect a business to include a set of budgeted financial statements in the loan request package. Of course, we did demand to see the latest financial statements of the business. Very few of our smaller business clients prepared budgets. Although many businesses do not prepare budgets, they do establish detailed goals and performance objectives that serve as good benchmarks for management control.

Every business – whether it does budgeting or not – should design internal accounting reports that provide the information managers need to control the business. Obviously, managers should keep close tabs on what's going on throughout the business. Some years ago, in one

> of my classes, I (Colin) asked students for a short definition of management control. One student answered that management control means ‘watching everything’. That’s not bad.

A business may not do any budgeting, and thus it does not prepare budgeted financial statements. But its managers should receive regular profit and loss accounts, balance sheets and cash flow statements – and these key internal financial statements should contain detailed management control information. Other specialised accounting reports may be needed as well.

Most business managers, in our experience, would tell you that the accounting reports they get are reasonably good for management control. Their accounting reports provide the detailed information they need for keeping a close watch on the thousand and one details about the business (or their particular sphere of responsibility in the business organisation). Their main criticisms are that too much information is reported to them and all the information is flat, as if all the information is equally relevant. Managers are very busy people, and have only so much time to read the accounting reports coming to them. Managers have a valid beef on this score, we think. Ideally, significant deviations and problems should be highlighted in the accounting reports they receive – but separating the important from the not-so-important is easier said than done.

If you were to ask a cross section of business managers how useful their accounting reports are for making decisions, you would get a different answer than how good the accounting reports are for management control. Business managers make many decisions affecting profit: setting sales prices, buying products, determining wages and salaries, hiring independent contractors and purchasing fixed assets are just a few that come to mind. Managers should carefully analyse how their actions would impact profit before reaching final decisions. Managers need internal profit and loss accounts that are good profit models – that make clear the critical variables that affect profit (see Figure 9-2 for an example). Well-designed management profit and loss accounts are absolutely essential for helping managers make good decisions.

Keep in mind that almost all business decisions involve non-financial and non-quantifiable factors that go beyond the information included in management accounting reports. For example, the accounting department of a business can calculate the cost savings of a wage cut, or the elimination of overtime hours by employees, or a change in the retirement plan for employees – and the manager would certainly look at this data. But such decisions must consider many other factors such as effects on employee morale and productivity, the possibility of the union going out on strike, legal issues and so on. In short, accounting reports provide only part of the information needed for business decisions, though an essential part for sure.

Needless to say, the internal accounting reports to managers should be clear and straightforward. The manner of presentation and means of communication should be attention getting. A manager should not have to call the accounting department for an explanation. Designing management accounting reports is a separate topic – one beyond the limits of this book.

In the absence of budgeting by a business, the internal accounting reports to its managers become the major – often the only – regular source of financial information to them. Without budgeting, the internal accounting reports have to serve a dual function – both for control and for planning. The managers use the accounting reports to critically review what's happened (control), and use the information in the reports to make decisions for the future (planning).

Before leaving the topic, we have one final observation to share with you. Many management accounting reports that we've seen could be improved. Accounting systems, unfortunately, give so much attention to the demands of preparing external financial statements and tax returns that the needs managers have for good internal reports are too often overlooked or ignored. The accounting reports in many businesses do not speak to the managers receiving them – the reports are too voluminous and technical, and are not focused on the most urgent and important problems facing the managers. Designing good internal accounting reports for managers is a demanding task, to be sure. Every business should take a hard look at its internal management accounting reports and identify what needs to be improved.

Budgeting in Action

Suppose you're the general manager of one of a large company's several divisions. You have broad authority to run this division, as well as the responsibility for meeting the financial expectations for your division. To be more specific, your profit responsibility is to produce a satisfactory annual operating profit, or earnings before interest and tax (EBIT). (Interest and tax expenses are handled at a higher level in the organisation.)

The CEO has made clear to you that she expects your division to increase EBIT during the coming year by about 10 per cent (£256,000, to be exact). In fact, she has asked you to prepare a budgeted management profit and loss account showing your plan for increasing your division's EBIT by this target amount.

She also has asked you to prepare a budgeted cash flow from profit based on your profit plan for the coming year.

Figure 10-1 presents the management profit and loss account of your division for the year just ended. The format of this accounting report follows the profit model discussed in Chapter 9, which explains profit behaviour and how to increase profit. Note that fixed operating expenses are separated from the two variable operating expenses. To simplify the discussion, we've significantly condensed your management profit and loss account. (Your actual reports would include much more detailed information about sales and expenses.) Also, we assume that you sell only one product to keep the number crunching to a minimum.

Figure 10-1: Management profit and loss account for year just ended.

	Totals for Period	Per Unit
Unit Sales Volume =	26,000	
Sales Revenue	£ 26,000,000	£1,000.00
Cost of Goods Sold Expense	14,300,000	550.00
Gross Margin	£ 11,700,000	£450.00
Revenue-driven Operating Expenses	2,080,000	80.00
Volume-driven Operating Expenses	1,300,000	50.00
Contribution Margin	£ 8,320,000	£320.00
Fixed Operating Expenses	5,720,000	
Operating Profit	£ 2,600,000	

TECHNICAL STUFF

Most businesses, or the major divisions of a large business, sell a mix of several different products. General Motors, for example, sells many different makes and models of cars and commercial vehicles, to say nothing about its other products. The next time you visit your local hardware store, look at the number of products on the shelves. The assortment of products sold by a business and the quantities sold of each that make up its total sales revenue is referred to as its *sales mix*. As a general rule, certain products have higher profit margins than others. Some products may have extremely low profit margins, which are called *loss leaders*. The marketing strategy for loss leaders is to use them as magnets to get customers to buy your higher profit margin products along with their purchase of the loss leaders. Shifting the sales mix to a higher proportion of higher profit margin products has the effect of increasing the average profit margin on all products sold. (A shift to lower profit margin products would have the opposite effect, of course.) Budgeting sales revenue and expenses for the coming year must include any planned shifts in the company's sales mix.

Developing your profit strategy and budgeted profit and loss account

Suppose that you and your managers, with the assistance of your accounting staff, have analysed your fixed operating expenses line by line for the coming year. Some of these fixed expenses will actually be reduced or eliminated next year. But the large majority of these costs will continue next year, and most are subject to inflation. Based on careful studies and estimates, you and your staff forecast that your total fixed operating expenses for next year will be £6,006,000 (including £835,000 depreciation expense, compared with the £780,000 depreciation expense for last year).

Thus, you will need to earn £8,862,000 total contribution margin next year:

£2,856,000	EBIT goal (£2,600,000 last year plus £256,000 budgeted increase)
+ 6,006,000	Budgeted fixed operating expenses next year
£8,862,000	Total contribution margin goal next year

This is your main profit budget goal for next year, assuming that fixed operating expenses are kept in line. Fortunately, your volume-driven variable operating expenses should not increase next year. These are mainly transportation costs, and the shipping industry is in a very competitive 'hold-the-price-down' mode of operations that should last through the coming year. The cost per unit shipped should not increase, but if you sell and ship more units next year, the expense will increase in proportion.

You have decided to hold the revenue-driven operating expenses at 8 per cent of sales revenue during the coming year, the same as for the year just ended. These are sales commissions, and you have already announced to your sales staff that their sales commission percentage will remain the same during the coming year. On the other hand, your purchasing manager has told you to plan on a 4 per cent product cost increase next year – from £550 per unit to £572 per unit, or an increase of £22 per unit. Thus, your unit contribution margin would drop from £320 to £298 (if the other factors that determine margin remain the same).

One way to attempt to achieve your total contribution margin objective next year is to load all the needed increase on sales volume and keep sales price the same. (We're not suggesting that this strategy is a good one, but it's a good point of departure.) At the lower unit contribution margin, your sales volume next year would have to be 29,738 units:

> £8,862,000 total contribution margin goal ÷ £298 contribution margin per unit = 29,738 units sales volume

Compared with last year's 26,000 units sales volume, you would have to increase your sales by over 14 per cent. This may not be feasible.

After discussing this scenario with your sales manager, you conclude that sales volume cannot be increased 14 per cent. You'll have to raise the sales price to provide part of the needed increase in total contribution margin and to offset the increase in product cost. After much discussion, you and your sales manager decide to increase the sales price by 3 per cent. Based on the 3 per cent sales price increase and the 4 per cent product cost increase, your unit contribution margin next year is determined as follows:

Unit Contribution Margin Next Year

Sales price	£1,030.00
Less: Product cost	572.00
Less: Revenue-driven operating expenses	82.40
Less: Volume-driven variable operating expenses	50.00
Equals: Contribution margin per unit	£325.60

At this £325.60 budgeted contribution margin per unit, you determine the total sales volume needed next year to reach your profit goal as follows:

> £8,862,000 total contribution margin goal next year ÷ £325.60 contribution margin per unit = 27,217 units sales volume

This sales volume is about 5 per cent higher than last year (1,217 additional units over the 26,000 sales volume last year = about 5 per cent increase).

If you don't raise the sales price, your division has to increase sales volume by 14 per cent (as calculated above). If you increase the sales price by just 3 per cent, the sales volume increase you need to achieve your profit goal next year is only 5 per cent. Does this make sense? Well, this is just one of many alternative strategies for next year. Perhaps you could increase sales price by 4 per cent. But, you know that most of your customers are sensitive to a sales price increase, and your competitors may not follow with their own sales price increase.

After lengthy consultation with your sales manager, you finally decide to go with the 3 per cent sales price increase combined with the 5 per cent sales volume growth as your official budget strategy. Accordingly, you forward your budgeted management profit and loss account to the CEO. Figure 10-2 summarises this profit budget for the coming year. This summary-level budgeted management profit and loss account is supplemented with appropriate schedules to provide additional detail about sales by types of customers and other relevant information. Also, your annual profit plan is broken down into quarters (perhaps months) to provide benchmarks for comparing actual performance during the year against your budgeted targets and timetable.

Figure 10-2: Budgeted profit and loss account for coming year.

	Totals for Period	Per Unit
Unit Sales Volume =	27,217	
Sales Revenue	£ 28,033,968	£1,030.00
Cost of Goods Sold Expense	15,568,378	572.00
Gross Margin	£ 12,465,590	£458.00
Revenue-driven Operating Expenses	2,242,717	82.40
Volume-driven Operating Expenses	1,360,872	50.00
Contribution Margin	£ 8,862,000	£325.60
Fixed Operating Expenses	6,006,000	
Operating Profit	£ 2,856,000	

Budgeting cash flow from profit for the coming year

The budgeted profit plan (refer to Figure 10-2) is the main focus of attention, but the CEO also requests that all divisions present a *budgeted cash flow from profit* for the coming year. ***Remember:*** The profit you're responsible for as general manager of the division is earnings before interest and tax (EBIT) – not net income after interest and tax.

Chapter 7 explains that increases in debtors, stock and prepaid expenses *hurt* cash flow from profit and that increases in creditors and accrued liabilities *help* cash flow from profit. You should compare your budgeted management profit and loss account for the coming year (Figure 10–2) with your actual statement for last year (Figure 10–1). This side-by-side comparison (not shown here) reveals that sales revenue and all expenses are higher next year.

Therefore, your short-term operating assets, as well as the liabilities that are driven by operating expenses, will increase at the higher sales revenue and expense levels next year – unless you can implement changes to prevent the increases.

For example, sales revenue increases from £26,000,000 last year to the budgeted £28,033,968 for next year – an increase of £2,033,968. Your debtors balance was five weeks of annual sales last year. Do you plan to tighten up the credit terms offered to customers next year – a year in which you will raise the sales price and also plan to increase sales volume? We doubt it. More likely, you will keep your debtors balance at five weeks of annual sales. Assume that you decide to offer your customers the same credit terms next year. Thus, the increase in sales revenue will cause debtors to increase by £195,574 (5⁄52 × £2,033,968 sales revenue increase).

Last year, stock was 13 weeks of annual cost of goods sold expense. You may be in the process of implementing stock reduction techniques. If you really expect to reduce the average time stock will be held in stock before being sold, you should inform your accounting staff so that they can include this key change in the balance sheet and cash flow models. Otherwise, they will assume that the past ratios for these vital connections will continue next year.

Figure 10-3 presents a summary of your budgeted cash flow from profit (the EBIT for your division) based on the information given for this example and using the ratios explained in Chapter 7 for short-term operating assets and liabilities. For example, debtors increases by £195,574, as just explained. And, stock increases by £317,095 (13⁄52 × £1,268,378 cost of goods sold expense increase). ***Note:*** Increases in accrued interest payable and income tax payable are not included in your budgeted cash flow. Your profit responsibility ends at the operating profit line, or earnings before interest and income tax expenses.

You submit this budgeted cash flow from profit statement (Figure 10–3) to top management. Top management expects you to control the increases in your short-term assets and liabilities so that the actual cash flow generated by your division next year comes in on target. The cash flow from profit of your division (minus the small amount needed to increase the working cash balance held by your division for operating purposes) will be transferred to the central treasury of the business.

Figure 10-3: Budgeted cash flow from profit statement for coming year.

Budgeted Operating Profit (See Figure 10-2)	£2,856,000
Accounts Receivable Increase	(195,574)
Inventory Increase	(317,095)
Prepaid Expenses Increase	(26,226)
Depreciation Expense	835,000
Accounts Payable Increase	34,968
Accrued Expenses Payable Increase	52,453
Budgeted Cash Flow From Operating Profit	£3,239,526

Business budgeting versus government budgeting: Only the name is the same

Business and government budgeting are more different than alike. Government budgeting is preoccupied with allocating scarce resources among many competing demands. From national agencies down to local education authorities, government entities have only so much revenue available. They have to make very difficult choices regarding how to spend their limited tax revenue.

Formal budgeting is legally required for almost all government entities. First, a budget request is submitted. After money is appropriated, the budget document becomes legally binding on the government agency. Government budgets are legal straitjackets; the government entity has to stay within the amounts appropriated for each expenditure category. Any changes from the established budgets need formal approval and are difficult to get through the system.

A business is not legally required to use budgeting. A business can use its budget as it pleases and can even abandon its budget in midstream. Unlike the government, the revenue of a business is not constrained; a business can do many things to increase sales revenue. In short, a business has much more flexibility in its budgeting. Both business and government should apply the general principle of cost/benefits analysis to make sure that they are getting the best value for money. But a business can pass its costs to its customers in the sales prices it charges. In contrast, government has to raise taxes to spend more.

Capital Budgeting

This chapter focuses on profit budgeting for the coming year, and budgeting the cash flow from that profit. These two are hardcore components of business budgeting – but not the whole story. Another key element of the budgeting process is to prepare a *capital expenditures budget* for top management review and approval. A business has to take a hard look at its long-term operating assets – in particular, the capacity, condition and efficiency of these resources – and decide whether it needs to expand and modernise its fixed assets. In most cases, a business would have to invest substantial sums of money in purchasing new fixed assets or retrofitting and upgrading its old fixed assets. These long-term investments require major cash outlays. So, a business (or each division of the business) prepares a formal list of the fixed assets to be purchased or upgraded. The money for these major outlays comes from the central treasury of the business. Accordingly, the capital expenditures budget goes to the highest levels in the organisation for review and final approval. The chief financial officer, the CEO and the board of directors of the business go over a capital expenditure budget request with a fine-tooth comb.

At the company-wide level, the financial officers merge the profit and cash flow budgets of all divisions. The budgets submitted by one or more of the divisions may be returned for revision before final approval is given. One main concern is whether the collective total of cash flow from all the units provides enough money for the capital expenditures that have to be made during the coming year for new fixed assets – and to meet the other demands for cash, such as for cash distributions from profit. The business may have to raise more capital from debt or equity sources during the coming year to close the gap between cash flow from profit and its needs for cash. The financial officers need to be sure that any proposed capital expenditures make good business sense. We look at this in the next three sections. If the expenditure is worthwhile, they may need to raise more money to pay for it. We cover that subject in Chapter 18.

Deducing payback

The simplest way to evaluate an investment is to calculate *payback* – how long it takes you to get your money back. Figure 10-4 shows an investment that calls for £20,000 cash up front in the expectation of getting £25,000 cash back over the next five years. The investment is forecasted to return a total of £20,000 by the end of year 4, so we say that this investment has a four-year payback.

Figure 10-4: Calculating payback.

	£
Initial cost of investment	20,000
Annual net cash inflows	
Year 1	1,000
Year 2	4,000
Year 3	8,000
Year 4	7,000
Year 5	5,000
Total cash in	25,000

When calculating the return on long-term investments, we use cash rather than profit. This is because we need to compare like with like: Investments are paid for in cash or by committing cash, so we need to calculate the return using cash, too.

Let's suppose that we have two competing projects from which we have to choose only one. Figure 10-5 sets out the maths. Both projects have a four-year payback, in that the outlay is recovered in that period; so this technique tells us that both projects are equally acceptable, as long as we are content to recover our outlay by year 4.

However, this is only part of the story. We can see at a glance that Project 2 produces £9,000 more cash over five years than Project 1 does. We also get a lot more cash back in the first two years with Project 2, which must be better – as well as safer for the investor. Payback fails to send those signals, but is still a popular tool because of its simplicity.

Figure 10-5: Comparing investments using payback.

	£ **Project 1**	£ **Project 2**
Initial cost of investment	20,000	20,000
Annual net cash inflows		
Year 1	1,000	3,000
Year 2	4,000	5,000
Year 3	8,000	8,000
Year 4	7,000	8,000
Year 5	5,000	10,000
Total cash in	25,000	34,000

Discounting cash flow

A pound today is more valuable than a pound in one, two or more years' time. For us to make sound investment decisions, we need to ask how much we would pay now to get a pound back at some date in the future. If we know we can earn 10 per cent interest from a bank, then we would only pay out 90p now to get that pound in one year's time. The 90p represents the *Net Present Value* (NPV) of that pound – the amount we would pay now to get the cash at some future date.

In effect what we're doing is discounting the future cash flow using a percentage that equates to the minimum return that we want to earn. The further out that return, the less we would pay now in order to get it.

The formula we use to discount the cash flow is:

Present Value (PV) = $£P \times 1/(1+r)^n$

where £P is the initial investment, r is the interest expressed as a decimal, and n is the year when the cash will flow in. (For example, in year 1 n =1, in year 2 it will be 2 and so on). So if we require a 15 per cent return, we should only be prepared to pay £0.87 now to get £1 in one year's time, £0.76 for a pound in two years' time and just £0.50 now for a pound coming in five years' time.

Take a look at Figure 10-6. If we use a discount rate of 15 per cent (which is a very average return on capital for a business) the picture doesn't look so rosy. Far from paying back in four years and producing £25,000 cash for an outlay of £20,000, Project 1 is actually paying out less money (£15,642) in real terms, allowing for the time value of money, than we have paid out.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Cash in	1,000	4,000	8,000	7,000	5,000	25,000
NPV of cash	870	3,025	5,260	4,002	2,486	15,642

Figure 10-6: Comparing cash with the Net Present Value of that cash at 15 per cent discount rate.

Calculating the internal rate of return

Net Present Value is a powerful concept, though a slightly esoteric one. All we know so far about our attempt to evaluate Project 1 is that if we aim for a return of 15 per cent, our returns will be disappointing. So, we move on to the next stage in our quest for a sound way to appraise capital investment proposals – calculating exactly what the return on investment will be.

To arrive at this figure we need to calculate the actual return the project made on the discounted cash flow – the *Internal Rate of Return* (IRR). To do this, we need to find the value for '*r*' in the Net Present Value formula (see the section 'Discounting cash flow') that ensures the present value of the future cash flow equals the cost of the investment. In the case of Project 1, the IRR is just short of 7 per cent. You would fare little worse by leaving the money on deposit in a bank, in this case.

The IRR is a number you can use to compare one project with another to assess quickly which is superior from a financial point of view. For example, Project 2 has an IRR of 17 per cent, which is clearly better than that of Project 1, a fact not revealed by using the payback method.

The Solutions Matrix website (www.solutionmatrix.com) has a very neat tool for working out payback, discounted cash flow, Internal Rate of Return and a whole lot more calculations relating to capital budgeting. You have to register on the site first before downloading their free capital budgeting spreadsheet suite and tutorial. Just go to the home page and click on 'Download Center' and 'Download Financial Metrics Lite for Microsoft Excel'.

Arriving at the cost of capital

No new capital investment would make much sense if it didn't at least cover the cost of the capital used to finance it. This cost is known in the trade as the *hurdle rate*, as that is the level of return any project has to beat. Say you've worked out the cost of equity (steam ahead to Chapter 11 if you're less than familiar with this term) as being 15 per cent. That should cover the dividends and the fairly high costs associated with raising the dosh. Next comes the cost of borrowed capital (and that of any other long-term source of finance such as hire purchase or mortgages). That figure is usually fairly self-evident as the lender will state this up front; however you may have to make a judgment call here if your loans have a *variable rate of interest*; that is, one that can go up and down with the general bank rate. Then you have to make an educated guess as to what that might be over the life of the loan.

Next you need to combine the cost of equity and debt capital into one overall cost of capital figure; in essence, your hurdle rate.

An average cost is required because you don't usually identify each individual project with one particular source of finance. Generally businesses take the view that all projects have been financed from a common pool of money except for the relatively rare case when project specific finance is raised.

Assume your company intends to keep the gearing ratio of borrowed capital to equity in the proportion of 20:80. (Push ahead to chapter 14 if gearing is not a term in your Scrabble vocabulary). The cost of new capital from these sources has been assessed, say, at 10 per cent and 15 per cent respectively and corporation tax is 30 per cent. The calculation of the overall weighted average cost is as follows:

Type of capital	Proportion(a)	After-tax cost (b)	Weighted cost (a x b)
10% loan capital	0.20	7.0%	1.4%
Equity	0.80	15.0%	12.0%
			13.4%

The resulting weighted average cost of 13.4 per cent is the minimum rate that this company should accept on proposed investments. Any investment that isn't expected to achieve this return isn't a viable proposition.

Reporting On Variances

Any performance needs to be carefully monitored and compared against the budget as the year proceeds, and corrective action must be taken where necessary to keep the two consistent. This has to be done on a monthly basis (or using shorter time intervals if required), showing both the company's performance during the month in question and throughout the year so far.

Looking at Figure 10-7 you can see at a glance that the business is behind on sales for this month, but ahead on the yearly target. The convention is to put all unfavourable variations in brackets. Hence, a higher-than-budgeted sales figure doesn't have brackets, while a higher materials cost does. You can also see that, while profit is running ahead of budget, the profit margin is slightly behind (–0.30 per cent). This is partly because other direct costs, such as labour and distribution in this example, are running well ahead of budgeting variances.

Figure 10-7: Fixed Budget – note figures rounded up and down to nearest thousand may affect percentages.

Heading	*Month*			*Year to date*		
	Budget	*Actual*	*Variance*	*Budget*	*Actual*	*Variance*
Sales	805*	753	(52)	6,358	7,314	956
Materials	627	567	60	4,942	5,704	(762)
Materials margin	178	186	8	1,416	1,610	194
Direct costs	74	79	(5)	595	689	(94)
Gross profit	104	107	3	820	921	101
Percentage	**12.92**	**14.21**	**1.29**	**12.90**	**12.60**	**(0.30)**

Flexing your budget

A budget is based on a particular set of sales goals, few of which are likely to be met exactly in practice. Figure 10-7 shows that the business has used £762,000 more materials than budgeted. As more has been sold, this is hardly surprising. The way to manage this situation is to flex the budget to show what would be expected to happen to expenses, given the sales that actually occurred. This is done by applying the budget ratios to the actual data. For example, materials were planned to be 22.11 per cent of sales in the budget. By applying that to the actual month's sales, you arrive at a materials cost of £587,000.

Looking at the flexed budget in Figure 10-8 you can see that the business has spent £19,000 more than expected on the material given the level of sales actually achieved, rather than the £762,000 overspend shown in the fixed budget. The same principle holds for other direct costs, which appear to be running £94,000 over budget for the year. When you take into account the extra sales shown in the flexed budget, you can see that the company has actually spent £4,000 over budget on direct costs. While this is serious, it isn't as serious as the fixed budget suggests. The flexed budget allows you to concentrate your efforts on dealing with true variances in performance.

Figure 10-8: Flexed Budget – note figures rounded up and down to nearest thousand may affect percentages.

Heading	*Month*			*Year to date*		
	Budget	*Actual*	*Variance*	*Budget*	*Actual*	*Variance*
Sales	753*	753	–	7,314	7,314	–
Materials	587	567	20	5,685	5,704	(19)
Materials margin	166	186	20	1,629	1,610	(19)
Direct costs	69	79	(10)	685	689	(4)
Gross profit	97	107	10	944	921	(23)
Percentage	**12.92**	**14.21**	**1.29**	**12.90**	**12.60**	**(0.30)**

Staying Flexible with Budgets

One thing never to lose sight of is that budgeting is a *means to an end*. It's a tool for doing something better than you could without the tool. Preparing budgeted financial statements is not the ultimate objective; a budget is not an end in itself. The budgeting process should provide definite benefits, and businesses should use their budgeted financial statements to measure progress toward their financial objectives – and not just file them away someplace.

Budgets are not the only tool for management control. Control means accomplishing your financial objectives. Many businesses do not use budgeting and do not prepare budgeted financial statements. But they do lay down goals and objectives for each period and compare actual performance against these targets. Doing at least this much is essential for all businesses.

Keep in mind that budgets are not the only means for controlling expenses. Actually, we shy away from the term *controlling* because we've found that, in the minds of most people, *controlling* expenses means minimising them. The *cost/benefits* idea captures the better view of expenses. Spending more on advertising, for example, may have a good payoff in the additional sales volume it produces. In other words, it's easy to cut advertising to zero if you really want to minimise this expense – but the impact on sales volume may be disastrous.

Business managers should eliminate any *excessive* amount of an expense – the amount that really doesn't yield a benefit or add value to the business. For example, it's possible for a business to spend too much on quality inspection by doing unnecessary or duplicate steps, or by spending too much time testing products that have a long history of good quality. But this doesn't mean that the business should eliminate the expense entirely. Expense control means trimming the cost down to the right size. In this sense, expense control is one of the hardest jobs that business managers do, second only to managing people, in our opinion.

Chapter 11

Choosing the Right Ownership Structure

In This Chapter

- Seeing profit as a small piece of the sales revenue pie
- Taking stock of the company as an important ownership structure
- Watching out for negative factors affecting share value
- Discerning profit allocation and liability issues
- Looking out for Number One in a sole proprietorship
- Deciding on the best ownership structure for tax purposes

The obvious reason for investing in a business as an owner rather than a safer kind of investment is the potential for greater rewards. As one of the partners or shareholders of a business, you're entitled to part of the business's profit – and you're also subject to the risk that the business will go down the tubes, taking your money down with it. This chapter shows you how ownership structure affects your share of the profit – especially how changes beyond your control can make your share less valuable. It also explains how the ownership structure has a dramatic impact on the taxes paid by the business and its owners.

From the Top Line to the Bottom Line

Chapter 5 explains the business profit-making process and the accounting profit report for a period, which is called the *profit and loss account.* The chapter focuses on the financial effects on the various operating assets and operating liabilities of a business of its sales revenue and expense activities. To make sense of a company's *balance sheet* (its statement of financial condition at the end of the profit period), which is explained in Chapter 6, you need to understand how its sales revenue and expenses propel the company's operating assets and operating liabilities. And to round out the financial picture of a business, you need to look at its sources and uses of cash flows for the period, which are presented in its *cash flow statement* – see Chapter 7.

Whew! These three business financial statements present a lot of information. But, if you're a manager or owner of a business you should have a good grip on these three *accounting reports* (as they're sometimes called). Accounting is often called the language of business, and learning the basic vocabulary of accounting is extraordinarily helpful, if not downright essential, for business managers and owners.

There is one aspect of the business profit-making process that it is easy to lose sight of when reading a profit and loss account. How does a business get from the top line in its profit and loss account (sales revenue) down to its bottom line (net income)?

In our free enterprise, largely unregulated and non-government-controlled economy, business managers have the responsibility of negotiating the prices paid for labour, subject only to minimum wages legislation, and most of the other services, supplies and other factors used in the profit-making process. This book isn't the place to delve into the fields of labour economics and political economy. But we would point out that business profit and loss accounts are one key source of information for scholars who do research in these areas. In particular, the financial statements prepared by accountants report how sales revenue is divided among the different parties in a business's profit-making process.

A business collects money from its customers and then redistributes that sales revenue to the many parties clamouring for their fair share. You may think that the second part of this process would be the easy part, but business managers sometimes have a tough time deciding what constitutes a fair share for each claimant. For example, in deciding how much to pay employees in regular wages and fringe benefits, business managers have to ask what value each employee adds to the business, whether to raise sales prices in order to pay higher wages and so on.

The distribution of total sales revenue among the various claimants on the revenue is a *zero-sum game*. This means that if one party gets a bigger piece of the revenue pie then some other party gets a smaller piece, keeping the size of the pie (total sales revenue) the same. (The alternative is for the business to increase the size of its sales revenue pie – by raising its sales prices or selling more units.) If a business increases compensation to its employees, for instance, without changing the prices paid for all other services and supplies, then the shares of total sales revenue going to the Chancellor in tax and to the owners as after-tax net income decrease. (Note that a business may increase wages expecting that labour productivity gains will offset the wage gains.) Business managers must constantly calculate how changes in the prices they charge customers and changes in the prices they pay for labour, materials, products, utilities and many other expenses affect bottom-line profit.

Net income, or net profit as it is often referred to, is the bottom-line profit that the business earned this period (or, to be more precise, the period just concluded, which often is called ‘this period’ to mean the most recent period). This figure is the starting point for determining how much cash – if any – to distribute to the owners. Businesses are not legally required to distribute any of their profit for the period, but if they do distribute some or all of their profit, the amounts distributed to each owner depend on the business’s ownership structure, as described in the following section, ‘What Owners Expect for Their Money’.

The owners of a business, in a real sense, stand at the end of the line for their piece of the sales revenue pie. How can you tell whether a business is doing well for its owners? What’s a good net income figure? One test is to compare bottom-line profit with sales revenue. Dividing profit by sales revenue gives the *profit ratio*, which is expressed as a percentage. Many people don’t really know what’s a typical profit ratio for a business. They think it’s high – 20 per cent, 30 per cent or even 50 per cent of sales revenue. In fact, the large majority of businesses earn profit ratios of less than 10 per cent.

Although profit ratio is a useful test of profit performance, it ignores the amount of capital the owners have tied up in the business. Every business needs owners’ capital to invest in the assets needed for making profit. The ratio of profit over owners’ equity is called *return on equity*. To calculate a business’s return on equity (ROE) you divide net income by total owners’ equity (you can find owners’ equity listed on the business’s balance sheet). Compare the ROE of a business with the ROEs of investment alternatives that have the same kinds of risks and advantages when you’re deciding whether to invest in a business. Business managers keep a close watch on their ROE in order to judge their business’s profit performance relative to the amount of its owners’ capital being used to make that profit.

> *Equity* is a term used to describe the capital put in by the owners either on start-up, left in from past profits generated, or by way of additional investment to help the venture grow. It is also referred to as owners’ equity, because those who put up equity own the business. The term *risk capital* is also used, as the owners of a business put their capital at risk. If things go seriously wrong they can lose their shirts, and more besides. Lenders such as banks enjoy a measure of protection because their money is usually secured against an asset such as property, equipment, machinery or even a motor vehicle. All such assets are likely to have some value worth recovering, even though it might not be enough to cover the whole sum involved.

Usually, managers have an ownership interest in the business – although in large, public companies, managers usually own only a small percentage of the total owners’ equity. For a small business, the two or three chief managers may be the only owners. But many small businesses have outside, non-manager investors who put money in the business and share in the profit that the business earns. Chapter 14 explains more about ROE and other ways outside investors interpret the information in a business's external financial report.

What Owners Expect for Their Money

Every business – regardless of how big it is and whether it's publicly or privately owned – has owners; no business can get all the financing it needs just by borrowing. An *owner* is someone who:

- Invested money in the business when it originally raised capital from its owners or who bought ownership shares from one of the existing owners of the business.
- Expects the business to earn profit on the owners' capital and expects to share in that profit by receiving cash distributions from profit and by benefiting from increases in the value of the ownership shares – with no guarantee of either.
- Directly participates in the management of the business or hires others to manage the business – in smaller businesses an owner may be one of the managers or may sit on the board of directors of the business, but in very large businesses you are just one of thousands of owners who elect a representative board of directors to oversee the managers of the business and to protect the interests of the owners.
- Receives a proportionate share of the proceeds if the business is sold or if the business sells off its assets.

- Takes risks and may lose the amount of their shareholding.

When owners invest money in a business, the accountant records the amount of money received as an increase in the company's *cash* account (note the account is not called 'money'). And, to keep things in balance, the amount invested in the business is recorded as an increase in an *owners' equity* account. (This is one example of *double entry accounting*, which is explained in Chapter 2.) Owners' equity also increases when a business makes profit. Because of the two different reasons for increases, the owners' equity of a business is divided into two separate accounts:

- **Share capital (also referred to as invested capital):** Represents the amounts of money that owners have invested in the business, which could have been many years ago. Owners may invest additional capital from time to time, but generally speaking they cannot be forced to put additional money in a business.
- **Retained earnings (also referred to as reserves):** Represents the profit earned by a business over the years that has not been distributed to its owners. If all profit has been distributed every year, retained earnings will have a zero balance. (If a business has never made a profit, its accumulated loss will cause retained earnings to have a negative balance, called a *deficit*.) If none of the annual profits of a business have been distributed to its owners, the balance in retained earnings will be the cumulative profit earned by the business since it opened its doors.

The account title *retained earnings* for the profit that a business earns and does not distribute to its owners is appropriate for any type of business entity. Business companies – one of the most common types of business entities – use this title. The other types of business entities discussed in this chapter may use this title, but they may collapse both sources of owners' equity into just one account for each owner. Companies are legally required to distinguish between the two sources of owners' equity: invested capital versus retained earnings. The other types of business entities may not be.

Whether to retain some or all of annual net income is one of the most important decisions that a business makes; distributions from profit have to be decided at the highest level of a business. A growing business needs additional capital for expanding its assets, and increasing the debt load of the business usually cannot supply all the additional capital. So, the business *ploughs back* some of its profit for the year – it keeps some (perhaps all) of the profit, rather than giving it out to the owners. In the long run this may be the best course of action, a step back before a leap forward.

Banks are one major source of loans to businesses. Of course, banks charge interest on the loans; a business and its bank negotiate an interest rate acceptable to both. Also, many other conditions are negotiated, such as the term (time period) of the loan, whether collateral is required to secure the loan and so on. The loan contract between a business and its lender may prohibit the business from distributing profit to owners during the period of the loan. Or, the loan agreement may require that the business maintain a minimum cash balance – which could mean that money the business would like to distribute to owners from profit has to stay in its cash account instead.

The chairman or other appropriate officer of the business signs the lending agreement with the bank. In addition, the bank may ask the major investors in the business to sign the agreement *as individuals*, in their personal capacities – and perhaps ask their spouses to sign the agreement as well. You should definitely understand your personal obligations if you are considering signing a lending agreement for a business. You take the risk that you may have to pay some part – or perhaps all – of the loan out of your personal assets.

Now, who are the owners and how do they organise themselves? A business may have just one owner, or two or more owners. A one-owner business may choose to operate as a *sole trader* or *proprietorship*; a multi-owner business must choose to be a *partnership*, a *limited partnership* or a *limited liability company*. The most ordinary type of business is a sole trader – there are 1.5 million of them in the UK. Around a million limited companies are in operation at present, too.

No ownership structure is inherently better than another; which one is right for a particular business is something that the business's managers and owners need to decide (or should consult a tax adviser about, as discussed later in this chapter). The following discussion focuses on how ownership structure affects profit distribution to owners. Later, this chapter explains how the ownership structure determines the tax paid by the business and its owners – which is always an important consideration.

Companies

The law views a *company* as a person. Like an adult, a company is treated as a distinct and independent individual who has rights and responsibilities. A company's 'birth certificate' is the legal form that is filed if the company is domiciled in the UK. A company must have a legal name, of course, like an individual. Just as a child is separate from his or her parents, a company is separate from its owners. The company is responsible for its own debts, just like a person is. The bank can't come after you if your neighbour defaults on his or her loan, and the bank can't come after you if the company you have invested money in goes belly up. If a company doesn't pay its debts, its creditors can seize only the company's assets, not the assets of the company's owners.

You can find out everything you need to know about registering a company from Companies House at www.companieshouse.gov.uk/infoAndGuide/companyRegistration.shtml.

This important legal distinction between the obligations of the business entity and its individual owners is known as *limited liability* – that is, the limited liability of the owners. Even if the owners are excessively wealthy they have no legal liability for the unpaid debts of the company (unless they've used the corporate shell to defraud creditors, or are trading in some fraudulent or illegal manner). So, when you invest money in a company as an owner, you know that the most you can lose is the same amount you put in. You may lose every pound you put in, but that's the most you can lose. The company's creditors cannot reach through the corporate entity to grab your assets to pay off the liabilities of the business.

Stock shares

A company issues ownership shares to persons who invest money in the business. These ownership shares are documented by *stock certificates*, which state the name of the owner and how many shares are owned. The company has to keep a *register* (list) of how many shares everyone owns, of course. (An owner can be another company, or any other legal entity.) The owners of a company are called its *shareholders* because they own *shares* issued by the company. The shares are fully *negotiable*, which means the owner can sell them at any time to anyone willing to buy them without having to get the approval of the company or the other shareholders to sell the shares. *Publicly owned companies* are those whose shares are traded in public markets, most notably the London Stock Exchange, the New York Stock Exchange and NASDAQ (National Association of Securities Dealers Automated Quotation).

One share is one unit of ownership; how much one share is worth with respect to the value of the whole business depends on the total number of shares that the business issues. If a business has issued 400,000 shares and you own 40,000 of them, you own 1⁄10 of the business. But suppose that the business issues an additional 40,000 shares; you now have 40,000 of 440,000, giving you a 1⁄11 interest in the business. The more shares a business issues, the smaller the percentage of total owners' equity each share represents. Issuing additional shares may dilute, or decrease the value of each share of stock. A good example is when a publicly owned company doubles the number of its shares by issuing a two-for-one stock split. Each shareholder gets one new share for each share presently owned, without investing any additional money in the business. As you would expect, the market value of the stock drops in half – which is exactly the purpose of the split, because the lower stock price is better for stock market trading (according to conventional wisdom).

If new shares are issued at a price equal to the going value of the shares, the value of the existing shares should not be adversely affected. But if new shares are issued at a discount from the going value, the value of each share after the additional shares are issued may decline. For example, assume you own shares in a business and the shares are selling for £100 per share. Suppose the company issues some shares for £50 per share. Each new share adds only £50 value to the business, which drags down the average value of all shares of the company. We quickly admit here that the valuation of company shares is not nearly so simple – but our purpose is to emphasise that shareholders should pay attention to the issue of additional shares for less than the going market price of a company's shares. Management stock options are the prime example of issuing shares at below market prices.

JARGON ALERT

Many publicly owned companies give their managers share options in addition to their salaries and other benefits. A *share option* gives a manager the legal right to buy a certain number of shares at a fixed price starting at some time in the future – assuming conditions of continued employment and other requirements are satisfied. Usually the *exercise price* (also called the *strike price*) of a management share option is set equal to or higher than the present market value of the shares. So, granting the manager the share option does not produce any immediate gain to the manager – and these options can't be exercised for some time anyway. If the market price of the shares rises above the exercise price of the share option sometime in the future, the share options become valuable – indeed, many managers have become multi-millionaires from their share options.

Suppose that the market value of a company's shares has risen to, say, $100 and that the exercise price of the share options awarded to several managers a few years ago was set at $50 per share. And, assume that all the other conditions of the share options are satisfied. The managers' share options will certainly be exercised to realise their gains. It would seem, therefore, that the management share options would have a negative impact on the market price of the company's shares – because the total value of the business has to be divided over a larger number of shares and this results in a smaller value per share. On the other hand, it can be argued that the total value of the business is higher than it would have been without the management share options, because better qualified managers were attracted to the business or the managers performed better because of their options. Even with the decrease in the value per share, it is argued, the shareholders are better off than they would have been if no share options had been awarded to the managers. The shares' market value may have been only $90 or $80 without the management share options – so the story goes.

Classes of shares

Before you invest in shares, you should ascertain whether the company has issued just one *class* of share. A class is one group, or type, of share all having identical rights; every share is the same as every other share. A company can issue two or more different classes of shares. For example, a business may offer Class A and Class B shares, where Class A shareholders are given the vote in elections for the board of directors but Class B shareholders do not get a vote. Of course, if you want to vote in the annual election of directors you should buy Class A shares. Laws generally are very liberal regarding the different classes of shares that can be issued by companies. For a whimsical example, one class could get the best seats at the annual meetings of the shareholders. To be serious, differences between classes of shares are very significant and affect the investment value of the shares of each class of share.

Two classes of corporate shares are fundamentally different: *ordinary shares* (called *common shares* in the US) and *preference shares*. Preference shareholders are promised a certain amount of cash dividends each year (note we said ‘promised’, not ‘guaranteed’) – but the company makes no such promises to its ordinary shareholders. If the business ends up liquidating its assets and after paying off its liabilities returns money to its owners, the preference shareholders have to be paid before any money goes to the ordinary shareholders. The ordinary shareholders are at the top of the risk chain: A business that ends up in deep financial trouble is obligated to pay off its liabilities first, and then its preferred shareholders, and by the time the ordinary shareholders get their turn the business may have no money left to pay them. So, preference shareholders have the promise of annual dividends and stand ahead of ordinary shareholders in the liquidation of the business. What’s the attraction of ordinary shares, therefore? The main advantage of ordinary shares is that they have unlimited upside potential. After obligations to its preference shareholders are satisfied, the rest of the profit earned by the company accrues to the benefit of its ordinary shareholders.

The main difference between preference shares and ordinary shares concerns *cash dividends* – what the business pays its owners from its profit. Here are the key points:

- A business must pay dividends to its preference shareholders because it has a contractual obligation to do so, whereas each year the board of directors must decide how much, if any, cash dividends to distribute to its ordinary shareholders. You can find details of the average dividend paid by companies at any one time in the *Financial Times*. At the time of writing, this average stands at 3.1 per cent.
- Preference shareholders usually are promised a fixed (limited) dividend per year and typically don't have a claim to any profit beyond the stated amount of dividends. (Some companies issue *participating preference shares* or convertible preference shares, which give the preference shareholders a contingent right to more than just their basic amount of dividends, something which gets too technical for this book.)
- Preference shareholders don't have voting rights – unless they don't receive dividends for one period or more. In other words, preference shareholders usually do not have voting rights in electing the company's board of directors or on other critical issues facing the company. Needless to say, these matters can become complex, and they vary from company to company – no wonder there are so many corporate lawyers! If you need more information we recommend *Investing For Dummies* by Tony Levene (Wiley).

Here are some other general things to know about ordinary shares:

- Each share is equal to every other share in its class. This way, ownership rights are standardised, and the main difference between two shareholders is how many shares each owns.
- The only way a business has to return shareholders' capital (composed of invested capital and retained earnings) is if the majority of shareholders vote to liquidate the business in part or in total. Other than that, the business's managers don't have to worry about losing the shareholders' capital. Of course, shareholders are free to sell their shares at any time, as noted next.
- A shareholder can sell his or her shares at any time, without the approval of the other shareholders. However, shareholders of a privately owned business may have agreed to certain restrictions on this right when they invested in the business. Additionally, the stock market takes a dim view of shareholders who also work in a business suddenly dumping a whole lot of shares without having a compelling reason to do so. You can find details of directors' dealings in their own shares by going to www.investegate.co.uk and clicking on 'Company Announcements' followed by 'News'.
- Shareholders can either put themselves in key management positions or delegate the task of selecting top managers and officers to a *board of directors*, which is a small group of persons selected by the shareholders to set the business's policies and represent shareholders' interests. If you put up more than half the money in a business, you can put yourself on the board and elect yourself president of the business. The shareholders who own 50 per cent plus one share constitute the controlling group that decides who goes on the board of directors.

If you want to sell your shares, how much can you get for them? Shares in privately owned businesses aren't publicly traded, so how can you determine the value of your shares in such a business? To be frank, you can't really. Until you actually sell your shares for a certain price per share, you simply don't know their market value for sure. On the other hand, you can use certain benchmarks, or valuation methods, to estimate market value. For example, you could look to the *book value per share*, which is based on values reported on the business's latest balance sheet:

> Total shareholders' equity ÷ total number of shares = book value per share

Book values are historical – based on the past transactions of the business – whereas market pricing looks to how the business is likely to do in the future. The past is important, but the future prospects of the business are more important in setting a value on the business. Market value depends on forecast profit performance (future earnings), which in many cases is much more important than book value per share. One way of estimating the value of your shares in a private business company is the *earnings multiple* method, in which you calculate the theoretical value of a share by using a certain multiple of the business's earnings (net income) per share.

Suppose a privately owned business company earned £3.20 net income per share last year. You calculate the book value per share at the end of the year, which, let's assume, is £20. You may be able to sell your shares at ten times earnings per share, or £32 per share, which is considerably more than the book value per share. If someone paid £32 per share for the shares and the business earned £3.20 per share next year, the new shareholder might be satisfied to earn 10 per cent on his or her £32 investment – calculated by dividing the £3.20 earnings per share by the £32 cost of the share. (Not all of the £3.20 may be paid out as a cash dividend, so part of the 10 per cent earnings on the investment consists of the increase in retained earnings of the business.)

Keep in mind that the £32 market value is only an estimate and just a theoretical price. However, you don't know the market price until you sell the shares. As potential investors in the business, we may be willing to offer you £35 or £40 per share – or we may offer less than the book value per share.

Shareholders and managers

Shareholders (including managers who own shares in the business) are concerned, first and foremost, with the profit performance of their business. The dividends they receive, and the value of their shares, depend on profit. Managers, too, are concerned with profit – their jobs depend on living up to the business's profit goals. But even though shareholders and managers strive toward the common goal of making the business profitable, they have an inherent conflict of interest that revolves around money and power:

- The more money that managers make in wages and benefits, the less shareholders see in the bottom-line net income. Shareholders obviously want the best managers for the job, but they don't want to pay any more than they have to. In many companies, top-level managers, for all practical purposes, set their own salaries and compensation packages.

  The best solution is often to have outside directors (with no management position in the business) set the compensation of the top-level managers instead.

- Who should control the business: the managers, who were hired for their competence and are intimately familiar with the business, or the shareholders, who probably have no experience relevant to running this particular business but who put up the money that the business is running on? In ideal situations, the two sides respect each other's importance to the business and use this tension constructively. Of course, the real world is far from ideal, and you have situations in which managers are controlling the board of directors rather than the other way around. But this book isn't the proper place to get into all that.

In particular, watch out for actions that cause a *dilution effect* on the value of your shares – that is, cause each share to drop in value. Now, the dilution effect may be the result of a good business decision, so even though your share of the business has decreased in the short term, the long-term profit performance of the business (and, therefore, your investment) may benefit. But you need to watch these decisions closely. The following situations cause a dilution effect:

- A business issues additional shares at the going market value, but doesn't really need the additional capital – the business is in no better profit-making position than it was before issuing the new shares. For example, a business may issue new shares in order to let a newly hired chief executive officer buy them. The immediate effect may be a dilution in the market value per share. Over the long term, however, the new CEO may turn the business around and lead it to higher levels of profit performance that increase the share's value.
- A business issues new shares at a discount below its shares' current value. For example, the business may issue a new batch of shares at a price lower than the current market value to employees who take advantage of an employee share-purchase plan. Selling shares at a discount, by itself, has a dilution effect on the market value of the shares. But in the grand scheme of things, the share-purchase plan may motivate its employees to achieve higher productivity levels, which leads to superior profit performance of the business.

Where profit goes in a company

Suppose that your business earned £1.32 million in net income for the year just ended and has issued a total of 400,000 shares of capital stock. Divide net income by the number of shares, and you come up with earnings per share of £3.30.

The cash flow statement reports that the business paid £400,000 total cash dividends during the year, or £1 per share. (Cash dividends are usually paid half-yearly or sometimes quarterly, so the business most likely paid £0.25 dividends per share each of the four quarters.) The rest of the net income – £920,000 – remains in the retained earnings account. (***Remember:*** Net income is first entered as an increase in the retained earnings account, and distributions are taken out of this account.) The retained earnings account thus increased by £2.30 per share (the difference between the net income, or earnings per share, and the dividends per share).

Although shareholders don't have the cash to show for it, their investment is better off by £2.30 per share – which shows up in the balance sheet as an increase in the retained earnings account in owners' equity. They can just hope that the business will use the cash flow provided from profit this year to make more profit in the future, which should lead to higher cash dividends.

If the business is a publicly owned company whose shares are actively traded, its shareholders look to the change in the *market price* of the stock shares during the year. Did the market value go up or down during the year? You may think that the market value should increase £2.30 per share, because the business earned this much per share that it kept in the business and did not distribute to its shareholders. Your thinking is quite logical: Profit is an increase in the net assets of a business (assets less liabilities). The business is £2.30 per share richer at the end of the year than it was at the start of the year, due to profit earned and retained.

Yet it's entirely possible that the market price of the stock shares actually *decreased* during the year. Market prices are governed by psychological, political and economic factors that go beyond the information in the financial reports of a business. Financial statements are one – but only one – of the information sources that stock investors use in making their buy-and-sell decisions. Chapter 14 explains how stock investors use the information in financial reports.

Partnerships and limited partnerships

> Suppose you're starting a new business with one or more other owners, but you do not want it to be a company. You can choose to form a *partnership* or a *limited partnership*, which are the main alternatives to the corporate form of a business. ***Note:*** A partnership is sometimes also called a *firm*. (You don't see this term used to refer to a company nearly as often as you do to a partnership.) The term firm connotes an association of a group of individuals working together in a business or professional practice, as in a *firm of lawyers*.

Compared with the relatively rigid structure of companies, partnership and limited partnership ownership structures allow the division of management authority, profit sharing, and ownership rights among the owners to be very flexible. Here are the key features of these two ownership structures:

- **Partnerships:** Partnerships avoid the double-taxation feature that companies are subject to (see 'Choosing the Right Legal Structure for Tax Purposes', later in this chapter, for details). Partnerships also differ from companies with respect to liability. A partnership's owners fall into two categories:
  - **General partners** are subject to *unlimited liability*. If a business can't pay its debts, its creditors can reach into general partners' personal assets. General partners have the authority and responsibility to manage the business. They are roughly equivalent to the managing director and

other high-level managers of a business company. The general partners usually divide authority and responsibility among themselves, and often they elect one member of their group as the senior general partner or elect a small executive committee to make major decisions.

- **Limited partners** escape the unlimited liability that the general partners have hanging around their necks. You can reduce the more painful consequences of entering a partnership by having your involvement registered as a limited partnership. A limited partnership is very different from a 'general' partnership. It is a legal animal that, in certain circumstances, combines the best attributes of a partnership and a corporation.

A limited partnership works like this. There must be one or more general partners with the same basic rights and responsibilities (including unlimited liability) as in any general partnership and one or more limited partners who are usually passive investors. The big difference between a general partner and a limited partner is that the limited partner isn't personally liable for debts of the partnership. The most a limited partner can lose is the amount that he or she paid or agreed to pay into the partnership as a capital contribution; or received from the partnership after it became insolvent.

To keep this limited liability, a limited partner may not participate in the management of the business, with very few exceptions. A limited partner who does get actively involved in the management of the business risks losing immunity from personal liability and having the same legal exposure as a general partner.

Caution: We would advise you as a member of a partnership, either as a general or limited partner, to get up to speed on the special accounting practices of the business regarding how salaries and other payments for services to owners and partners are accounted for in the entity's financial statements and how they are treated in determining annual taxable income. Don't take anything for granted; investigate first. Call a tax professional if you have questions or need advice in this area.

Partnerships are effectively collections of sole traders or proprietors. It is a common structure used by people who started out on their own, but want to expand. There are very few restrictions to setting up in business with another person (or persons) in partnership, and several definite advantages. By pooling resources you may have more capital; you will be bringing, hopefully, several sets of skills to the business; and if you are ill, the business can still carry on.

The legal regulations governing partnerships in essence assume that competent businesspeople should know what they are doing. The law merely provides a framework of agreement, which applies 'in the absence of agreement to the contrary'. It follows from this that many partnerships are entered into without legal formalities and sometimes without the parties themselves being aware that they have entered a partnership! Just giving the impression that you are partners may be enough to create an 'implied partnership'.

In the absence of an agreement to the contrary, these rules apply to partnerships:

- All partners contribute capital equally.
- All partners share profits and losses equally.

- No partner shall have interest paid on their capital.
- No partner shall be paid a salary.
- All partners have an equal say in the management of the business.

It is unlikely that all these provisions will suit you, so you would be well advised to get a partnership agreement drawn up in writing before trading.

Partnerships have three serious financial drawbacks that merit particular attention.

1. If your partner makes a business mistake, perhaps by signing a disastrous contract without your knowledge or consent, every member of the partnership must shoulder the consequences. Under these circumstances, your personal assets could be taken to pay the creditors, even though the mistake was no fault of your own.
2. If your partner goes bankrupt in their personal capacity, for whatever reason, his or her creditors can seize their share of the partnership. As a private individual you are not liable for your partner's private debts, but having to buy them out of the partnership at short notice could put you and the business in financial jeopardy.
3. If your partnership breaks up for any reason, those continuing with it will want to recover control of the business; those who remain shareholders will want to buy back shares; the leaver wants a realistic price. The agreement you have on setting up the business should specify the procedures, and how to value the leaver's share, otherwise resolving the situation will be costly. The traditional route to value the leaver's share is to ask an independent accountant. This is rarely cost-effective. The valuation costs money and worst of all it is not definite and consequently there is room for

argument. Another way is to establish a formula, an agreed eight times the last audited pre-tax profits, for example. This approach is simple but difficult to get right. A fast-growing business is undervalued by a formula using historic data unless the multiple is high; a high multiple may overvalue 'hope' or goodwill, thus unreasonably profiting the leaver. Under a third option, one partner offers to buy out the others at a price he specifies. If they do not accept his offer, the continuing partners must buy the leaver out at that price. In theory, such a price should be acceptable to all.

Even death may not release you from partnership obligations and in some circumstances your estate can remain liable. Unless you take public leave of your partnership by notifying your business contacts, and legally bringing your partnership to an end, you will remain liable indefinitely.

The partnership agreement specifies how to divide profit among the owners. Whereas owners of a company receive a portion of profit that's directly proportional to the number of shares they own and, therefore, how much they invested, a partnership does not have to divide profit according to how much each owner invested. Invested capital is only one of three factors that generally play into profit allocation in partnerships:

- **Treasure:** Owners may be rewarded according to how much of the 'treasure' – invested capital – they contributed; they get back a certain percentage (return) on their investment. So if Joe invested twice as much as Jane did, his cut of the profit may be set at twice as much as Jane's.
- **Time:** Owners who invest more time in the business may receive more of the profit. In some businesses, a partner may not contribute much more than capital and his or

her name, whereas other partners work long hours. This way of allocating profit works like a salary.

- **Talent:** Regardless of capital or time, some partners bring more to the business than others. Whatever it is that they do for the business, they contribute much more to the business's success than their capital or time suggests.

Note: A partnership needs to maintain a separate capital (or *ownership*) account for each partner. The total profit of the entity is allocated into these capital accounts, as spelled out in the partnership agreement. The agreement also specifies how much money each partner can withdraw from his capital account – for example, partners may be limited to withdrawing no more than 80 per cent of their anticipated share of profit for the coming year, or they may be allowed to withdraw only a certain amount until they've built up their capital accounts.

Sole proprietorships

A *sole proprietorship* or, as it is frequently known, *sole tradership*, is basically the business arm of an individual who has decided *not* to carry on his or her business activity as a separate legal entity (as a partnership, or limited liability company) – it's the default option. An individual may do house repair work for homeowners on a part-time basis, or be a full-time barber who operates on his own. Both are sole proprietorships. Anytime you regularly provide services for a fee, or sell things at a flea market, or engage in any business activity whose primary purpose is to make profit, you are a sole proprietor. If you carry on business activity to make profit or income, HM Revenue and Customs requires that you file a separate schedule summarising your profit or loss from trading with your annual individual income tax return. If your business activities are substantial, the Revenue may ask for both a profit and loss account and a balance sheet, but for most small businesses a few lines of figures showing income, main cost categories, and the resultant profit will be sufficient. As the sole owner (proprietor), you have *unlimited liability*, meaning that if your business can't pay all its liabilities, the creditors to whom your business owes money can come after your personal assets. Many part-time entrepreneurs may not know this or may put it out of their minds, but this is a big risk to take.

TIP

One other piece of advice for sole proprietors: Although you don't have to separate invested capital from retained earnings like companies do, you should still keep these two separate accounts for owners' equity – not only for the purpose of tracking the business but for the benefit of any future buyers of the business as well.

Spreading the joy of profit to your employees and customers: Business co-operatives

A *co-operative* pays its customers *patronage dividends* based on its profit for the year – each customer receives a year-end refund based on his or her purchases from the business over the year. Imagine that.

A co-operative is also an enterprise owned and controlled by the people working in it. Once in danger of becoming extinct, the workers' cooperative is enjoying something of a comeback with thousands being set up each year around Europe.

If this is to be your chosen legal form, you can pay from £90 to register with the Chief Registrar of Friendly Societies. You must have at least seven members at the outset, though they do not all have to be full-time workers at first. Like a limited company, a registered co-operative has limited liability (see 'Limited Liability Companies') for its members and must file annual accounts, but there is no charge for this. Not all co-operatives bother to register, as it is not mandatory, in which case they are treated in law as a partnership with unlimited liability.

Limited companies (Ltd) and public limited companies (plc)

As the name suggests, in this form of business your liability is limited to the amount you contribute by way of share capital.

A *limited company* has a legal identity of its own, separate from the people who own or run it. This means that, in the event of failure, creditors' claims are restricted to the assets of the company. The shareholders of the business are not liable as individuals for the business debts beyond the paid-up value of their shares. This applies even if the shareholders are working directors, unless of course the company has been trading fraudulently. In practice, the ability to limit liability is restricted these days as most lenders, including the banks, often insist on personal guarantees from the directors. Other advantages include the freedom to raise capital by selling shares.

Disadvantages include the legal requirement for the company's accounts to be audited and filed for public inspection.

A limited company can be formed by two shareholders, one of whom must be a director. A company secretary must also be appointed, who can be a shareholder, director or an outside person such as an accountant or lawyer.

The company can be bought 'off the shelf' from a registration agent, then adapted to suit your own purposes. This will involve changing the name, shareholders and articles of association and takes a couple of weeks to arrange. Alternatively, you can form your own company. But before you can form a company, you need to decide which of the two main structures of company to use.

A limited company (Ltd) is the most common type. This is a private company limited by shares. A limited company can be started with, say, an authorised share capital of £1,000. This is then divided into 1,000 × £1 shares. You can then issue as few or as many of the shares as you want. As long as the shares you have issued are paid for in full, if the company liquidates, the shareholders have no further liabilities. If the shares have not been paid for, the shareholders are liable for the value, that is, if they have 100 £1 shares, they only are liable for £100.

A *plc company* is a public limited company and may be listed on the Stock Exchange. Before a plc can start to trade it must have at least £50,000 of shares issued and at least 25 per cent of the value must have been paid for. A plc company has a better status due to its larger capital.

Choosing the Right Legal Structure for Tax Purposes

In deciding which type of ownership structure is best for securing capital and managing their business, owners should also consider the tax factor.

Taxable-entity companies pay tax on their annual taxable profit amounts. Their shareholders pay income tax on cash dividends that the business distributes to them from profit, making the company and its owners subject to double taxation. The owners (shareholders) of a company include in their individual income tax returns the cash distributions from profit paid to them by the business.

In the following examples, we assume that the business uses the same accounting methods in preparing its profit and loss account that it uses for determining its taxable income – a realistic assumption.

Companies

Whether trading as a limited company or public limited company, the tax rules are much the same. True, a small company, defined as one making less than a certain amount of profit, currently around £300,000 a year, may end up paying less tax than its bigger brothers, but the basic deal is the same.

Suppose you have a company with the following abbreviated profit and loss account (see Chapter 5 for details on profit and loss accounts):

Sales revenue	£26,000,000
Expenses, except corporation tax	(23,800,000)
Earnings before tax	£2,200,000
Corporation Tax	(748,000)
Net income	£1,452,000

The £748,000 corporation tax is determined by the fact that this business's £2.2 million taxable income puts it in the 34 per cent tax bracket (corporate taxable income rates have moved around the 30 per cent rate in recent years, but have been much higher and may yet be again. The actual rate makes no difference to the argument developed in this example):

£2,200,000 taxable income × 34% tax rate = £748,000 tax

That's a big chunk of the business's hard-earned profit. You must also consider the so-called *double taxation* of corporate profit – a most unpleasant topic if you're a shareholder in a company. Not only does the company have to pay £748,000 corporation tax on its profit (as we just calculated), but when the business distributes some of its after-tax profit to its shareholders as their just rewards for investing capital in the business, the shareholders include these cash dividends as income in their individual income tax returns and pay a second tax.

For a rather dramatic example, suppose that this business distributed its entire after-tax net income as cash dividends to its shareholders. (Even though most businesses don't pay 100 per cent cash dividends from their net incomes.) Its shareholders must include the cash dividends in their individual income tax returns. How much each individual pays in taxes depends on his or her total taxable income for the year, but let us make an arbitrary (but reasonable) assumption that the shareholders are, on average, in the marginal 31 per cent tax bracket. In this example, the shareholders would combine to pay £450,120 total individual income tax on their dividend incomes:

> £1,452,000 dividends × 31% income tax rate = £450,120 total individual income tax paid by shareholders

You can calculate the total tax paid by both the company and its shareholders as follows:

£748,000	paid by the company on its £2,200,000 taxable income
£450,120	paid by its shareholders on £1,452,000 in cash dividends
£1,198,120	total tax paid by both the company and its shareholders

Compare this to the company's £2,200,000 of taxable income. Out of the £2,200,000 pre-tax profit that the business earned, £1,198,120 is quite a bit of total tax to pay – more than half. On the other hand, if the company had retained all of its after-tax profit and paid no cash dividends, then at least for now the individual shareholders would not have to pay the second tax. Distributing no cash dividends may not go down well with all the shareholders, however. Most companies – but by no means all – pay part of their after-tax net income as cash dividends to their shareholders.

The distribution of profit to the shareholders in the dividend payment gives the appearance of taxing the same profit twice, but through a process of *tax credits* this double taxation doesn't generally occur. When a shareholder gets a dividend from a company, it comes with a tax credit attached. This means that any shareholder on the basic rate of tax won't have to pay any further tax. Higher rate taxpayers, however, have a further amount of tax to pay. So every shareholder takes a tax cash hit when dividends are distributed, but only higher rate taxpayers actually end up losing out.

Partnerships, limited liability partnerships and sole proprietorships

Sole traders (self-employed) have all their income from every source brought together and taxed as one entity. Partnerships are treated as a collection of sole traders for tax purposes, and each partner's share of that collective liability has to be worked out. Under the self-assessment tax system in the UK, the basis of a period of a year of assessment is the accounting year ending within that tax year. There are special rules that apply for the first year and the last year of trading that should ensure tax is charged fairly.

If your turnover is low, currently in the UK less than circa £15,000 per year, you can put in a three-line account on your standard tax return: sales, expenses and profit. No need for expensive accountancy advice here. If it is over whatever the current low figure is, then you have to summarise your accounts to show turnover, gross profit and expenses by main heading.

You will have a personal allowance: the current threshold below which you don't pay tax. That amount is deducted from the profit figure. All these rates and amounts are constantly changing, but the broad principles remain.

Partners don't actually get paid salaries, although partners may take monthly draws (withdrawals from the partnership) that may look like salaries. These may be listed as *drawings*. Partners are not employees but rather owners whose compensation consists of sharing in the profit of the partnership. A partner's share of profit may be disproportionately large, as a substitute for a salary, if that partner puts in more hours at the business or otherwise makes a disproportionate contribution. But the amount paid out is a withdrawal of profit by the partner and not a true salary.

Deciding which legal structure is best

The most important rule is never to let the 'tax tail wag the business dog'. Tax is just one aspect of business life. If you want to keep your business's finances private, then the public filing of accounts required of companies will not be for you. On the other hand, if you feel that you want to protect your private assets from creditors if things go wrong, then being a sole trader or partner is probably not the best route to take.

Company profits and losses are locked into the company, so if you have several lines of business using different trading entities, you cannot easily settle losses in one area against profits in another. But as sole traders are treated as one entity for all their sources of income, there is more scope for netting off gains and losses. Some points to bear in mind here are:

- If your profits are likely to be small, say below £60,000, for some time, then from a purely tax point of view you may pay less tax as a sole trader. This is because as an individual you get a tax-free allowance. Your first few thousand pounds of income are not taxable. This amount varies with personal circumstances, if you are married or single, for example, and can be changed in the budget each year.
- If you expect to be making higher rates of profit (above £60,000) and want to reinvest a large portion of those profits back into your business, then you could be better off forming a company. That is because companies don't start paying higher rates of tax until their profits are above £300,000. Even then they don't pay tax at 40 per cent. A sole trader would be taxed at the 40 per cent rate by the time their profits had reached about £35,000, taking allowances into account. So a company making £300,000 taxable profits could have around £50,000–£60,000 more to reinvest in financing future growth than would a sole trader in the same line of work.
- Non-salary benefits are more favourably treated for the sole trader. You can generally get tax relief on the business element of costs that are only partly business related, such as running a vehicle. A director of a company will be taxed on the value of the vehicle's list price and will not be allowed travel to and from work as a business expense.

Bear in mind that these calculations change with every change of tax rates in each budget.

Don’t let the tax tail wag the business dog! Your business needs to be structured to let you operate without taking undue financial risks. Tax is just one of a number of factors to weigh up when deciding how to legally structure your business. Although important, don’t let tax be the deciding factor.

Chapter 12

Cost Conundrums

In This Chapter

- Determining costs: The second most important thing accountants do
- Comprehending the different needs for cost information
- Contrasting costs to understand them better
- Determining product cost for manufacturers
- Padding profit by manufacturing too many products

Measuring costs is the second most important thing accountants do, right after measuring profit. But really, can measuring a cost be very complicated? You just take numbers off a purchase invoice and call it a day, right? Not if your business manufactures the products you sell – that's for sure! Businesses must carefully record all their costs correctly so that profit can be determined each period, and so that managers have the information they need to make decisions and to control profit performance.

Previewing What's Coming Down the Road

One main function of accounting for a manufacturing business is measuring *product cost*. Examples are the cost of a new car just rolling off the assembly line or the cost of this book, *Understanding Business Accounting For Dummies*. Most production (manufacturing) processes are fairly complex, so measuring product cost is also fairly complex in most cases. Every step in the production process has to be tracked very carefully from start to finish. One major problem is that many manufacturing costs cannot be directly matched with particular products; these are called *indirect costs*. To arrive at the *full cost* of each separate product manufactured, accountants devise methods for allocating the indirect production costs to specific products. Different accountants use different allocation methods. In other respects, as well, product cost accounting is characterised by a diversity of methods. Generally accepted accounting principles provide very little guidance for measuring product cost. Manufacturing businesses have a lot of leeway in how their product costs are determined; even businesses in the same industry use different product cost accounting methods.

In addition to measuring product costs of manufacturers, accountants in all businesses determine many other costs: the costs of the departments and other organisational units of the business; the cost of pensions for the company's employees; the cost of marketing initiatives and advertising campaigns; and, on occasion, the cost of restructuring the business or the cost of a major recall of products sold by the business. A common refrain among accountants is 'different costs for different purposes'. True enough, but at its core, cost accounting serves two broad purposes – measuring profit and providing relevant information to managers.

This chapter covers cost concepts and cost measurement methods that are used by both retail and manufacturing businesses, along with additional stuff for manufacturers to worry about. We also discuss how having a good handle on cost issues can help you recognise when a business is monkeying around with product cost to deliberately manipulate its profit figure. Service businesses – which sell a service such as transportation or entertainment – have a break here. They do not encounter the cost-accounting problems of manufacturers, but they have plenty of cost allocation issues to deal with in assessing the profitability of each of their separate sales revenue sources.

What Makes Cost So Important?

Without good cost information, a business operates in the dark. Cost data is needed for different purposes in business, including the following:

- **Setting sales prices:** The common method for setting sales prices (known as *cost-plus* or *mark-up on cost*) starts with cost and then adds a certain percentage.
- **Measuring gross margin:** Investors and managers judge business performance by the bottom-line profit figure. This profit figure depends on the *gross margin* figure that you get when you subtract your cost of goods sold expense from your sales revenue. Gross margin (also called *gross profit*) is the first profit line in the profit and loss account (see Figures 9–1 and 12–2 for examples).

- **Valuing assets:** The balance sheet reports cost values for many assets, and these values are, of course, included in the overall financial position of your business.
- **Making optimal choices:** You often must choose one alternative over others in making business decisions. The best alternative depends heavily on cost factors, and you have to be careful to distinguish *relevant* costs from *irrelevant* costs, as described in the section 'Relevant versus irrelevant (sunk) costs', later in this chapter.

  In most situations, the book value of a fixed asset is an *irrelevant* cost. Say the book value is £35,000 for a machine used in the manufacturing operations of the business. This is the amount of original cost that has not yet been charged to depreciation expense since it was acquired, and it may seem quite relevant. However, in deciding between keeping the old machine or replacing it with a newer, more efficient machine, the *disposable value* of the old machine is the relevant amount, not the non-depreciated cost balance of the asset. Suppose the old machine has only a £20,000 salvage value at this time. This is the relevant cost for the alternative of keeping it for use in the future – not the £35,000 that hasn't been depreciated yet. In order to keep using it, the business forgoes the £20,000 it could get by selling the asset, and this £20,000 is the relevant cost in the decision situation. Making decisions involves looking at the future cash flows of each alternative – not looking back at historical-based cost values.

Sharpening Your Sensitivity to Costs

The following sections explain important distinctions between costs that managers should understand in making decisions and exercising control. Also, these cost distinctions help managers better appreciate the cost figures that accountants attach to products that are manufactured or purchased by the business. In a later section we focus on the special accounting methods and problems of computing product costs of *manufacturers*. Retailers purchase products in a condition ready for sale to their customers – although the products have to be removed from shipping containers and a retailer does a little work making the products presentable for sale and putting the products on display.

Manufacturers don't have it so easy; their product costs have to be 'manufactured' in the sense that the accountants have to compile production costs and compute the cost per unit for every product manufactured. We cannot exaggerate the importance of correct product costs (for businesses that sell products, of course). The total cost of goods (products) sold is the first, and usually the largest, expense deducted from sales revenue in measuring profit. The bottom-line profit amount reported in the profit and loss account of a business for the period depends heavily on whether its product costs have been measured properly. Also, keep in mind that product cost is the value for the stock asset reported in the balance sheet of a business.

Direct versus indirect costs

What's the difference between these costs? Well:

- **Direct costs:** Can be clearly attributed to one product or product line, or one source of sales revenue, or one organisational unit of the business, or one specific operation in a process. An example of a direct cost in the book publishing industry is the cost of the paper that a book is printed on; this cost can be squarely attached to one particular phase of the book production process.
- **Indirect costs:** Are far removed from and cannot be obviously attributed to specific products, organisational units or activities. A book publisher's phone bill is a cost of doing business but can't be tied down to just one step in the book's editorial and production process. The salary of the purchasing officer who selects the paper for all the books is another example of a cost that is indirect to the production of particular books.

Indirect costs are allocated according to some methods to different products, sources of sales revenue, organisational units and so on. Most allocation methods are far from perfect, and in the last analysis end up being rather arbitrary. Business managers should always keep an eye on the allocation methods used for indirect costs, and take the cost figures produced by these methods with a grain of salt.

The cost of filling the fuel tank in driving your car from London to Bristol and back is a direct cost of making the trip. The annual road tax that the government charges you is an indirect cost of the trip, although it is a direct cost of having the car available during the year.

Fixed versus variable costs

Two other costs you need to know about are:

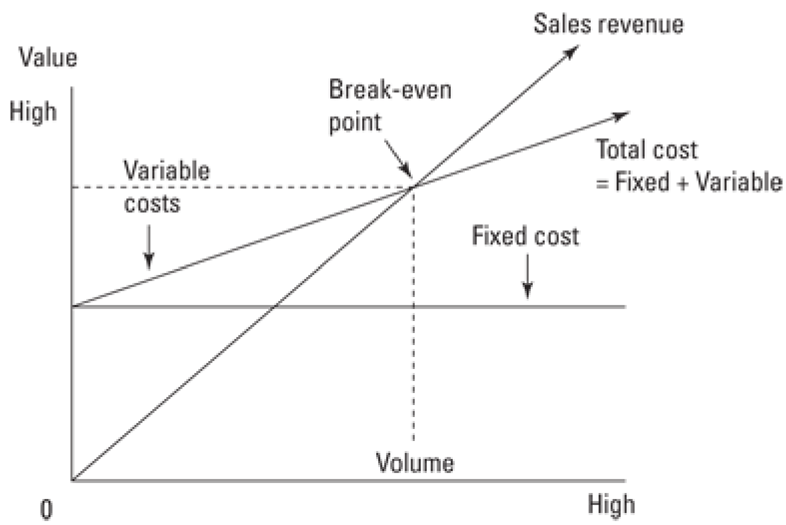
- **Fixed costs** remain the same over a relatively broad range of sales volume or production output. For example, the cost of renting office space doesn't change regardless of how much a business's sales volume increases or decreases. Fixed costs are like a dead weight on the business. Its total fixed costs form the hurdle that the business must overcome by selling enough units at high enough profit margins per unit in order to avoid a loss and move into the profit zone. (Chapter 9 explains the break-even point, which is the level of sales needed to cover fixed costs for the period.)
- **Variable costs** increase and decrease in proportion to changes in sales or production level. If you increase the number of books that your business produces, the cost of the paper and ink also goes up.

Breaking even

The saying goes that every picture is worth a thousand words. Well, 'finance' and 'pictures' are words that don't come together too often, but they certainly do when you look at costings.

Take a look at Figure 12-1. The bottom horizontal axis represents volume, starting at 0 and rising as the company produces more product. The vertical axis represents value, starting at 0 and rising, as you'd expect, with any increase in volume. The horizontal line in the middle of the chart represents *fixed costs* – those costs that remain broadly unchanged with increases in volume, rents and so on. The line angling upwards from the fixed cost line represents the *variable cost* – the more we produce, the higher the cost. We arrive at the total costs by adding the fixed and variable costs together.

Figure 12-1: A break-even chart.



On the hopeful assumption that our sales team has been hard at work, we should then see sales revenue kicking in. The line representing those sales starts at 0 (no sales means no money is coming in) then rises as sales grow. The crucial information this chart shows is the *break–even point,* when total costs have been covered by the value of sales revenue and the business has started to make profit. The picture makes it easier to appreciate why lowering cost, either fixed or variable, or increasing selling prices, helps a business to break even at lower volumes and hence start making profit sooner and be able to make even more profit from any given amount of assets.

Conversely, a business that only reaches break even when sales are so high that there is virtually no spare capacity is shown as being vulnerable, because that business has a small *margin of safety* if events don't turn out as planned.

Relevant versus irrelevant (sunk) costs

Is there such a thing as an irrelevant cost in business accounting? Sure:

- **Relevant costs:** Costs that should be considered when deciding on a future course of action. Relevant costs are *future* costs – costs that you would incur, or bring upon yourself, depending on which course of action you take. For example, say that you want to increase the number of books that your business produces next year in order to increase your sales revenue, but the cost of paper has just shot up. Should you take the cost of paper into consideration? Absolutely: That cost will affect your bottom-line profit and may negate any increases in sales volume that you experience (unless you increase the sales price). The cost of paper is a relevant cost.
- **Irrelevant (or sunk) costs:** Costs that should be disregarded when deciding on a future course of action: If brought into the analysis, these costs could cause you to make the wrong decision. An irrelevant cost is a vestige of the past; that money is gone, so get over it. For example, suppose that your supervisor tells you to expect a load of new recruits next week. All your staff members use computers now, but you have loads of typewriters gathering dust in the cupboard. Should you

consider the cost paid for those typewriters in your decision to buy computers for all the new staff? Absolutely not: That cost should have been written off and is no match for the cost you'd pay in productivity (and morale) for new employees who are forced to use typewriters.

Generally speaking, fixed costs are irrelevant when deciding on a future course of action, assuming that they're truly fixed and can't be increased or decreased over the short term. Most variable costs are relevant because they depend on which alternative is decided on.

TIP

Fixed costs are usually irrelevant in decision-making because these costs will be the same no matter which course of action you decide upon. Looking behind these costs, you usually find that the costs provide *capacity* of one sort or another – so much building space, so many machine-hours available for use, so many hours of labour that will be worked and so on. Managers have to figure out the best overall way to utilise these capacities.

Separating between actual, budgeted and standard costs

Other costs to know about are:

- **Actual costs:** Historical costs, based on actual transactions and operations for the period just ended, or going back to earlier periods. Financial statement accounting is based on a business's actual transactions and operations; the basic approach to determining annual profit is to record the financial effects of actual transactions and allocate historical costs to the periods benefited by the costs.

- **Budgeted costs:** Future costs, for transactions and operations expected to take place over the coming period, based on forecasts and established goals. Note that fixed costs are budgeted differently than variable costs – for example, if sales volume is forecast to increase by 10 per cent, variable costs will definitely increase accordingly, but fixed costs may or may not need to be increased to accommodate the volume increase (see 'Fixed versus variable costs', earlier in this chapter). Chapter 10 explains the budgeting process and budgeted financial statements.
- **Standard costs:** Costs, primarily in manufacturing, that are carefully engineered based on detailed analysis of operations and forecast costs for each component or step in an operation. Developing standard costs for variable production costs is relatively straightforward because many of these are direct costs, whereas most fixed costs are indirect, and standard costs for fixed costs are necessarily based on more arbitrary methods (see 'Direct versus indirect costs' earlier in this chapter). ***Note:*** Some variable costs are indirect and have to be allocated to specific products in order to come up with a full (total) standard cost of the product.

Product versus period costs

Product costs differ from period costs:

- **Product costs:** Costs attached to particular products. The cost is recorded in the stock asset account until the product is sold, at which time the cost goes into the cost of goods sold expense account. (See Chapters 5 and 6 for more about these accounts; also, see Chapter 13 for alternative methods for selecting which product costs are first charged to the cost of goods sold expense.) One key point to keep in mind is that product cost is deferred and not recorded to expense until the product is sold.

The cost of a new car sitting on a dealer's showroom floor is a product cost. The dealer keeps the cost in the stock asset account until you buy the car, at which point the dealer charges the cost to the cost of goods sold expense.

- **Period costs:** Costs that are *not* attached to particular products. These costs do not spend time in the 'waiting room' of stock. Period costs are recorded as expenses immediately; unlike product costs, period costs don't pass through the stock account first. Advertising costs, for example, are accounted for as period costs and recorded immediately in an expense account. Also, research and development costs are treated as a period cost.

Separating between product costs and period costs is particularly important for manufacturing businesses, as you find out in the following section.

Putting Together the Pieces of Product Cost for Manufacturers

Businesses that manufacture products have several additional cost problems to deal with. We use the term *manufacture* in the broadest sense: Car makers assemble cars, beer companies brew beer, oil companies refine oil, ICI makes products through chemical synthesis and so on. *Retailers*, on the other hand, buy products in a condition ready for resale to the end consumer. For example, Levi Strauss manufactures clothing, and Selfridges is a retailer that buys from Levi Strauss and sells the clothes to the public.

The following sections describe costs that are unique to manufacturers and address the issue of determining the cost of products that are manufactured.

Minding manufacturing costs

Manufacturing costs consist of four basic types:

- **Raw materials:** What a manufacturer buys from other companies to use in the production of its own products. For example, The Ford Motor Company buys tyres from Goodyear (and other tyre manufacturers) that then become part of Ford's cars.
- **Direct labour:** The employees who work on the production line.
- **Variable overhead:** Indirect production costs that increase or decrease as the quantity produced increases or decreases. An example is the cost of electricity that runs the production equipment: You pay for the electricity for the whole plant, not machine by machine, so you can't attach this cost to one particular part of the process. But if you increase or decrease the use of those machines, the electricity cost increases or decreases accordingly.

- **Fixed overhead:** Indirect production costs that do *not* increase or decrease as the quantity produced increases or decreases. These fixed costs remain the same over a fairly broad range of production output levels (see 'Fixed versus variable costs' earlier in this chapter). Three significant fixed manufacturing costs are:
  - Salaries for certain production employees who don't work directly on the production line, such as department managers, safety inspectors, security guards, accountants, and shipping and receiving workers.
  - Depreciation of production buildings, equipment and other manufacturing fixed assets.
  - Occupancy costs, such as building insurance, property rental, and heating and lighting charges.

Figure 12-2 shows a sample management profit and loss account for a manufacturer, including supplementary information about its manufacturing costs. Notice that the cost of goods sold expense depends directly on the product cost from the manufacturing cost summary that appears below the management profit and loss account. A business may manufacture 100 or 1,000 different products, or even more. To keep the example easy to follow, Figure 12-2 presents a scenario for a one-product manufacturer. The example is realistic yet avoids the clutter of too much detail. The multi-product manufacturer has some additional accounting problems, but these are too technical for a book like this. The fundamental accounting problems and methods of all manufacturers are illustrated in the example.

TIP

The information in the manufacturing cost summary schedule below the profit and loss account (see Figure 12-2) is highly confidential and for management eyes only. Competitors would love to know this information. A company may enjoy a significant cost advantage over its competitors and definitely would not want its cost data to get into the hands of its competitors.

Unlike a retailer, a manufacturer does not *purchase* products but begins by buying the raw materials needed in the production process. Then the manufacturer pays workers to operate the machines and equipment and to move the products into warehouses after they've been produced. All this is done in a sprawling plant that has many indirect overhead costs. All these different production costs have to be funnelled into the product cost so that the product cost can be entered in the stock account, and then to the cost of goods sold expense when products are sold.

Figure 12-2: Example for determining product cost of a manufacturer.

Management Profit and Loss Account for Year

	Per Unit	Totals
Sales Volume	110,000 Units	
Sales Revenue	£1,400	£154,000,000
Cost of Goods Sold Expense	(760)	(83,600,000)
Gross Margin	£640	£70,400,000
Variable Operating Expenses	(300)	(33,000,000)
Contribution Margin	£340	£37,400,000
Fixed Operating Expenses	(195)	(21,450,000)
Earnings Before Interest and Tax (EBIT)	£145	£15,950,000
Interest Expense		(2,750,000)
Earnings Before Tax		£13,200,000
Corporation Tax Expense		(4,488,000)
Net Income		£8,712,000

Manufacturing Cost Summary for Year

Annual Production Capacity 150,000 Units
Actual Output 120,000 Units

Production Cost Components	Per Unit	Totals
Raw Materials	£215	£25,800,000
Direct Labour	125	15,000,000
Variable Overhead	70	8,400,000
Total Variable Manufacturing Costs	£410	£49,200,000
Fixed Overhead	350	42,000,000
Total Manufacturing Costs	£760	£91,200,000
To 10,000 Units Stock Increase		(7,600,000)
To 110,000 Units Sold		£83,600,000

Allocating costs properly: Not easy!

Two vexing issues rear their ugly heads in determining product cost for a manufacturer:

- **Drawing a defining line between manufacturing costs and non- manufacturing operating costs:** The key difference here is that manufacturing costs are categorised as product costs, whereas non-manufacturing operating costs are categorised as period costs (refer to 'Product versus period costs' earlier in this chapter). In calculating product cost, you factor in only manufacturing costs and not other costs. Period costs are recorded right away as an expense – either in variable operating expenses or fixed operating expenses for the example shown in Figure 12-2.

Wages paid to production line workers are a clear-cut example of a manufacturing cost. Salaries paid to salespeople are a marketing cost and are not part of product cost; marketing costs are treated as period costs, which means these costs are recorded immediately to the expenses of the period. Depreciation on production equipment is a manufacturing cost, but depreciation on the warehouse in which products are stored after being manufactured is a period cost. Moving the raw materials and works-in-progress through the production process is a manufacturing cost, but transporting the finished products from the warehouse to customers is a period cost. In short, product cost stops at the end of the production line – but every cost up to that point should be included as a manufacturing cost. The accumulation of direct and variable production costs starts at the beginning of the manufacturing process and stops at the end of the production line. All fixed and indirect manufacturing costs during the year are allocated to the actual production output during the year.

If you mis-classify some manufacturing costs as operating costs, your product cost calculation will be too low (refer to 'Calculating product cost' later in this chapter).

- **Whether to allocate indirect costs among different products, organisational units or assets:** Indirect *manufacturing* costs must be allocated among the products produced during the period. The full product cost includes both direct and indirect manufacturing costs. Coming up with a completely satisfactory allocation method is difficult and ends up being somewhat arbitrary – but must be done to determine product cost. For non-manufacturing operating costs, the basic test of whether to allocate indirect costs is whether allocation helps managers make better decisions and exercise better control. Maybe, maybe not. In any case, managers should understand how manufacturing indirect costs are allocated to products and how indirect non-manufacturing costs are allocated, keeping in mind that every allocation method is arbitrary and that a different allocation method may be just as convincing. (See the sidebar 'Allocating indirect costs is as simple as ABC – not!')

Allocating indirect costs is as simple as ABC – not!

Accountants for manufacturers have developed loads of different methods and schemes for allocating indirect overhead costs, many based on some common denominator of production activity such as direct labour hours. The latest method to get a lot of press is called *activity-based costing* (ABC).

With the ABC method, you identify each necessary, supporting activity in the production process and collect costs into a separate pool for each identified activity. Then you develop a *measure* for each activity – for example, the measure for the engineering department may be hours, and the measure for the maintenance department may be square feet. You use the activity measures as *cost drivers* to allocate cost to products. So if Product A needs 200 hours of the engineering department's time and Product B is a simple product that needs only 20 hours of engineering, you allocate ten times as much of the engineering cost to Product A.

The idea is that the engineering department doesn't come cheap – including the cost of their computers and equipment as well as their salaries and benefits, the total cost per hour for those engineers could be £100 to £200. The logic of the ABC cost-allocation method is that the engineering cost per hour should be allocated on the basis of the number of hours (the driver) required by each product. In similar fashion, suppose the cost of the maintenance department is £10 per square foot per year. If Product C uses twice as much floor space as Product D, it will be charged with twice as much maintenance cost.

The ABC method has received much praise for being better than traditional allocation methods, especially for management decision making, but keep in mind that it still requires rather arbitrary definitions of cost drivers – and having too many different cost drivers, each with its own pool of costs, is not too practical. Cost allocation always involves arbitrary methods. Managers should be aware of which methods are being used and should challenge a method if they think that it's misleading and should be replaced with a better (though still somewhat arbitrary) method. We don't mean to put too fine a point on this, but to a large extent, cost allocation boils down to a 'my arbitrary method is better than your arbitrary method' argument.

Note: Cost allocation methods should be transparent to managers who use the cost data provided to them by accountants. Managers should never have to guess about what methods are being used, or have to call upon the accountants to explain the allocation methods.

Calculating product cost

The basic equation for calculating product cost is as follows (using the example of the manufacturer from Figure 12–2):

> \$91.2 million total manufacturing costs ÷ 120,000 units production output = \$760 product cost per unit

Looks pretty straightforward, doesn’t it? Well, the equation itself may be simple, but the accuracy of the results depends directly on the accuracy of your manufacturing cost numbers. And because manufacturing processes are fairly complex, with hundreds or thousands of steps and operations, your accounting systems must be very complex and detailed to keep accurate track of all the manufacturing costs.

As we explain earlier, when introducing the example, this business manufactures just one product. Also, its product cost per unit is determined for the entire year. In actual practice, manufacturers calculate their product costs monthly or quarterly. The computation process is the same, but the frequency of doing the computation varies from business to business.

KEY CONCEPT

In this example the business manufactured 120,000 units and sold 110,000 units during the year. As just computed, its product cost per unit is £760. The 110,000 total units sold during the year is multiplied by the £760 product cost to compute the £83,600,000 cost of goods sold expense, which is deducted against the company's revenue from selling 110,000 units during the year. The company's total manufacturing costs for the year were £91,200,000, which is £7,600,000 more than the cost of goods sold expense. This remainder of the total annual manufacturing costs is recorded as an increase in the company's stock asset account, to recognise the 10,000 units increase of units awaiting sale in the future. In Figure 12-2, note that the £760 product cost per unit is applied both to the 110,000 units sold and to the 10,000 units added to stock.

Note: As just mentioned, most manufacturers determine their product costs monthly or quarterly rather than once a year (as in the example). Product costs likely will vary each successive period the costs are determined. Because the product costs vary from period to period, the business must choose which cost of goods sold and stock cost method to use – unless product cost remains absolutely flat and constant period to period, in which case the different methods yield the same results. Chapter 13 explains the alternative accounting methods for determining cost of goods sold expense and stock cost value.

Fixed manufacturing costs and production capacity

Product cost consists of two very distinct components: *variable manufacturing costs* and *fixed manufacturing costs*. In Figure 12-2 note that the company's variable manufacturing costs are $410 per unit and that its fixed manufacturing costs are $350 per unit. Now, what if the business had manufactured just one more unit? Its total variable manufacturing costs would have been $410 higher; these costs are driven by the actual number of units produced, so even one more unit would have caused the variable costs to increase. But, the company's total fixed costs would have been the same if it had produced one more unit, or 10,000 more units for that matter. Variable manufacturing costs are bought on a per unit basis, as it were, whereas fixed manufacturing costs are bought in bulk for the whole period.

Fixed manufacturing costs are needed to provide *production capacity* – the people and physical resources needed to manufacture products – for the period. Once the business has the production plant and people in place for the year, its fixed manufacturing costs cannot be easily scaled down. The business is stuck with these costs over the short run. It has to make the best use it can from its production capacity.

Production capacity is a critical concept for business managers to grasp. You need to plan your production capacity well ahead of time because you need plenty of lead time to assemble the right people, equipment, land and buildings. When you have the necessary production capacity in place, you want to make sure that you're making optimal use of that capacity. The fixed costs of production capacity remain the same even as production output increases or decreases, so you may as well make optimal use of the capacity provided by those fixed costs.

The fixed cost component of product cost is called the *burden rate*. In our manufacturing example the burden rate is computed as follows (see Figure 12-2 for data):

> $42.0 million total fixed manufacturing costs for period ÷ 120,000 units production output for period = $350 burden rate

Note that the burden rate depends on the number divided into total fixed manufacturing costs for the period; that is, the production output for the period. Now, here's a very important twist on our example: Suppose the company had manufactured only 110,000 units during the period – equal exactly to the quantity sold during the year. Its variable manufacturing cost per unit would have been the same, or $410 per unit. But, its burden rate would have been $381.82 per unit (computed by dividing the $42 million total fixed manufacturing costs by the

110,000 units production output). Each unit sold, therefore, would have cost £31.82 more simply because the company produced fewer units (£381.82 burden rate at the 110,000 output level compared with the £350 burden rate at the 120,000 output level).

In this alternative scenario (in which only 110,000 units were produced), the company's product cost would have been £791.82 (£410 variable costs plus the £381.82 burden rate). The company's cost of goods sold, therefore, would have been £3,500,000 higher for the year (£31.82 higher product cost × 110,000 units sold). This rather significant increase in its cost of goods sold expense is caused by the company producing fewer units, although it did produce all the units that it needed for sales during the year. The same total amount of fixed manufacturing costs would be spread over fewer units of production output.

Shifting the focus back to the example shown in Figure 12-2, the company's cost of goods sold benefited from the fact that it produced 10,000 more units than it sold during the year – these 10,000 units absorbed £3.5 million of its total fixed manufacturing costs for the year, and until the units are sold, this £3.5 million stays in the stock asset account. It's entirely possible that the higher production level was justified – to have more stock on hand for sales growth next year. But production output can get out of hand – see the following section, 'Excessive production output for puffing up profit'.

REAL WORLD EXAMPLE

For the example illustrated in Figure 12-2, the business's production capacity for the year is 150,000 units. However, this business produced only 120,000 units during the year, which is 30,000 units fewer than it could have produced. In other words, it operated at 80 per cent of production capacity, which is 20 per cent *idle capacity* (which isn't unusual):

120,000 units output ÷ 150,000 units capacity = 80% utilisation

Running at 80 per cent of production capacity, this business's burden rate for the year is $350 per unit ($42 million total fixed manufacturing costs ÷ 120,000 units output). The burden rate would have been higher if the company had produced, say, only 110,000 units during the year. The burden rate, in other words, is sensitive to the number of units produced. This can lead to all kinds of mischief, as explained next.

Excessive production output for puffing up profit

Whenever production output is higher than sales volume, be on guard. Excessive production can puff up the profit figure. How? Until a product is sold, the product cost goes in the stock asset account rather than the cost of goods sold expense account, meaning that the product cost is counted as a *positive* number (an asset) rather than a *negative* number (an expense). The burden rate is included in product cost, which means that this cost component goes into stock and is held there until the products are sold later. In short, when you overproduce, more of your fixed manufacturing costs for the period are moved to the stock asset account and less are moved into cost of goods sold expense, which is based on the number of units sold.

TECHNICAL STUFF

The actual costs/actual output method and when not to use it

To determine its product cost, the business in the Figure 12-2 example uses the *actual cost/actual output method,* in which you take your actual costs – which may have been higher or lower than the budgeted costs for the year – and divide by the actual output for the year.

The actual costs/actual output method is appropriate in most situations. However, this method is not appropriate and would have to be modified in two extreme situations:

- **Manufacturing costs are grossly excessive or wasteful due to inefficient production operations:** For example, suppose that the business represented in Figure 12–2 had to throw away £1.2 million of raw materials during the year. The £1.2 million is included in the total raw materials cost, but should be removed from the calculation of the raw material cost per unit. Instead, you treat it as a period cost – meaning that you take it directly into expense. Then the cost of goods sold expense would be based on £750 per unit instead of £760, which lowers this expense by £1.1 million (based on the 110,000 units sold). But you still have to record the £1.2 million expense for wasted raw materials, so EBIT would be £100,000 lower.

- **Production output is significantly less than normal capacity utilisation:** Suppose that the Figure 12-2 business produced only 75,000 units during the year but still sold 110,000 units because it was working off a large stock carryover from the year before. Then its production capacity would be 50 per cent instead of 80 per cent. In a sense, the business wasted half of its production capacity, and you can argue that half of its fixed manufacturing costs should be charged directly to expense on the profit and loss account and not included in the calculation of product cost.

You need to judge whether a stock increase is justified. Be aware that an unjustified increase may be evidence of profit manipulation or just good old-fashioned management bungling. Either way, the day of reckoning will come when the products are sold and the cost of stock becomes cost of goods sold expense – at which point the cost subtracts from the bottom line.

Recapping the example shown in Figure 12-2: The business manufactured 10,000 more units than it sold during the year. With variable manufacturing costs at £410 per unit, the business took on £4.1 million more in manufacturing costs than it would have if it had produced only the 110,000 units needed for its sales volume. In other words, if the business had produced 10,000 fewer units, its variable manufacturing costs would have been £4.1 million less. That's the nature of variable costs. In contrast, if the company had manufactured 10,000 fewer units, its *fixed* manufacturing costs would not have been any less – that's the nature of fixed costs.

Of its £42 million total fixed manufacturing costs for the year, only £38.5 million ended up in the cost of goods sold expense for the year (£350 burden rate × 110,000 units sold). The other £3.5 million ended up in the stock asset account (£350 burden rate × 10,000 units stock increase). Let us be very clear here: We're not suggesting any hanky-panky. But the business did help its pre-tax profit to the amount of £3.5 million by producing

10,000 more units than it sold. If the business had produced only 110,000 units, equal to its sales volume for the year, then all the fixed manufacturing costs would have gone into cost of goods sold expense. As explained above, the expense would have been £3.5 million higher, and EBIT would have been that much lower.

Now suppose that the business manufactured 150,000 units during the year and increased its stock by 40,000 units. This may be a legitimate move if the business is anticipating a big jump in sales next year. But on the other hand, a stock increase of 40,000 units in a year in which only 110,000 units were sold may be the result of a serious overproduction mistake, and the larger stock may not be needed next year. In any case, Figure 12-3 shows what happens to production costs and – more importantly – what happens to profit at the higher production output level.

The additional 30,000 units (over and above the 120,000 units manufactured by the business in the original example) cost £410 per unit. (The precise cost may be a little higher than £410 per unit because, as you start crowding your production capacity, some variable costs may increase a little.) The business would need about £12.3 million more for the additional 30,000 units of production output:

> £410 variable manufacturing cost per unit × 30,000 additional units produced = £12,300,000 additional variable manufacturing costs invested in stock

But check out the business's EBIT in Figure 12-3: £23.65 million, compared with £15.95 million in Figure 12-2 – a £7.70 million increase, even though sales volume, sales prices and operating costs all remain the same. Whoa! What's going on here? The simple answer is that the cost of goods sold expense is £7.70 million less than before. But how can cost of goods sold expense be less? The business sells 110,000 units in both scenarios and variable manufacturing costs are $410 per unit in both cases.

The burden rate component of product cost in the first case is $350 (see Figure 12-2). In the second case the burden rate is only $280 (see Figure 12-3). Recall that the burden rate is computed by dividing total fixed manufacturing costs for the period by the production output during the period. Dividing by 150,000 units compared with 120,000 units reduces the burden rate from $350 to $280. The $70 lower burden rate multiplied by the 110,000 units sold results in a $7.7 million smaller cost of goods sold expense for the period, and a higher pre-tax profit of the same amount.

Figure 12-3: Example in which production output greatly exceeds sales volume, thereby boosting profit for the period.

Management Profit and Loss Account for Year

Sales Volume	110,000 Units	
	Per Unit	**Totals**
Sales Revenue	£1,400	£154,000,000
Cost of Goods Sold Expense	(690)	(75,900,000)
Gross Margin	£710	£78,100,000
Variable Operating Expenses	(300)	(33,000,000)
Contribution Margin	£410	£45,100,000
Fixed Operating Expenses	(195)	(21,450,000)
Earnings Before Interest and Tax (EBIT)	£215	£23,650,000
Interest Expense		(2,750,000)
Earnings Before Tax		£20,900,000
Corporation Tax Expense		(7,106,000)
Net Income		£13,794,000

Manufacturing Cost Summary for Year

Annual Production Capacity	150,000 Units	
Actual Output	150,000 Units	
Production Cost Components	**Per Unit**	**Totals**
Raw Materials	£215	£32,250,000
Direct Labour	125	18,750,000
Variable Overhead	70	10,500,000
Total Variable Manufacturing Costs	£410	£61,500,000
Fixed Overhead	280	42,000,000
Total Manufacturing Costs	£690	£103,500,000
To 40,000 Units Stock Increase		(27,600,000)
To 110,000 Units Sold		£75,900,000

In the first case the business puts £3.5 million of its total annual fixed manufacturing costs into the increase in stock (10,000 units increase × £350 burden rate). In the second case, in which the production output is at capacity, the business puts £11.2 million of its total fixed manufacturing costs into the increase in stock (40,000 units increase × £280 burden rate). Thus, £7.7 million more of its fixed manufacturing costs go into stock rather than cost of goods sold expense. But don't forget that stock increased 40,000 units, which is quite a large increase compared with the annual sales of 110,000 during the year just ended.

Who was responsible for the decision to go full blast and produce up to production capacity? Do the managers really expect sales to jump up enough next period to justify the much larger stock level? If they prove to be right, they'll look brilliant. But if the output level was a mistake and sales do not go up next year, they'll have you-know-what to pay next year, even though profit looks good this year. An experienced business manager knows to be on guard when stock takes such a big jump.

A View from the Top Regarding Costs

The CEO of a business gets paid to take the big-picture point of view. Using the business example in the chapter (refer to Figure 12-2 again), a typical CEO would study the management profit and loss account and say something like the following:

> *Not a bad year. Total costs were just about 90 per cent of sales revenue. EBIT per unit was a little more than 10 per cent of sales price (£145 per unit ÷ £1,400 sales price). I was able to spread my fixed operating expenses over 110,000 units of sales for an average of £195 per unit. Compared with the £340 contribution margin per unit, this yielded £145 EBIT per unit. I can live with this.*
>
> *I'd like to improve our margins, of course, but even if we don't, we should be able to increase sales volume next year. In fact, I notice that we produced 10,000 units more than we sold this year. So, I'll put pressure on the sales manager to give me her plan for increasing sales volume next year.*

I realise that cost numbers can be pushed around by my sharp-pencil accountants. They keep reminding me about cost classification problems between manufacturing and non-manufacturing costs – but, what the heck, it all comes out in the wash sooner or later. I watch the three major cost lines in my profit and loss account – cost of goods sold, variable operating expenses and fixed operating expenses.

I realise that some costs can be classified in one or another of these groupings. So, I expect my accountants to be consistent period to period, and I have instructed them not to make any changes without my approval. Without consistency of accounting methods, I can't reliably compare my expense numbers from period to period. In my view, it's better to be arbitrary in the same way, period after period, rather than changing cost methods to keep up with the latest cost allocation fads.

Chapter 13

Choosing Accounting Methods

In This Chapter

- Having a choice of accounting methods
- Understanding the alternatives for calculating cost of goods sold expense and stock cost
- Dealing with depreciation
- Writing down stock and debtors
- Keeping two sets of books

Some people put a great deal of faith in numbers: 2 + 2 = 4, and that's the end of the story. They see a number reported to the last digit on an accounting report, and they get the impression of exactitude. But accounting isn't just a matter of adding up numbers. It's not an exact science.

Accountants *do* have plenty of rules that they must follow. The official rule book of generally accepted accounting principles laid down by the Accounting Standards Board (and its predecessors) is more than 1,200 pages long and growing fast. In addition there are the rules and regulations issued by the various government regulatory agencies that govern financial reporting and accounting methods and those issued by publicly owned companies such as the London Stock Exchange. Also, the Institute of Chartered Accountants and the other professional accountancy institutes also play a role in setting accounting standards.

Although we're still in the early stages, standards are going *international* – the goal being to establish worldwide accounting standards. With the advent of the European Union and the ever-increasing amount of international trade and investing, business and political leaders in many nations recognise the need to iron out differences in accounting methods and disclosure standards from country to country.

Perhaps the most surprising thing – considering that formal rule-making activity has been going on since the 1930s – is that a business still has options for choosing among alternative accounting methods. Different methods lead to inconsistent profit measures from company to company. The often-repeated goal for standardising accounting methods is to make like things look alike and different things look different – but the accounting profession hasn't reached this stage of nirvana yet. In addition, accounting methods change over the years, as the business world changes. Accounting rules too are, to one degree or another, in a state of flux.

Because the choice of accounting methods directly affects the profit figure for the year and the values reported in the ending balance sheet, business managers (and investors) need to know the difference between accounting methods. You don't need to probe into these accounting methods in excruciating, technical detail, but you should at least know whether one method versus another yields higher or lower profit measures and higher or lower asset values in financial statements. This chapter explains accounting choices for measuring cost of goods sold, depreciation and other expenses. Get involved in making these important accounting decisions – it's your business, after all.

Decision-Making Behind the Scenes in Profit and Loss Accounts

Chapter 5 introduces the conventional format for presenting profit and loss accounts in *external* financial reports. (Also see Figure 9-1 for another example.) Figure 13-1 presents another profit and loss account for a business – with certain modifications that you won't see in actual external profit and loss accounts. For explaining the choices between alternative accounting methods, certain specific expenses are broken down under the company's sales, administrative and general expenses (SA&G) category in Figure 13-1. Of these particular expenses, only depreciation is disclosed in external profit and loss accounts. Don't expect to find in external profit and loss accounts the other expenses shown under the SA&G category in Figure 13-1. Businesses are very reluctant to divulge such information to the outside world.

Figure 13-1: A profit and loss account including certain expenses that are not reported outside the business.

Profit and Loss Account for Year		
Sales Revenue		£26,000,000
Cost of Goods Sold Expense		14,300,000
Gross Margin		£11,700,000
Sales, Administrative, and General Expenses:		
Stock Shrinkage and Write-downs	£378,750	
Bad Debts	385,000	
Asset Impairment Write-downs	287,000	
Depreciation	780,000	
Warranty and Guarantee Expenses	967,250	
All Other SA&G Expenses	6,302,000	
Total		9,100,000
Earnings Before Interest and Tax		£2,600,000
Interest Expense		400,000
Earnings Before Tax		£2,200,000
Corporation Tax Expense		880,000
Net Income		£1,320,000

Here's a quick overview of the accounting matters and choices relating to each line in the profit and loss account shown in Figure 13-1, from the top line to the bottom line:

- **Sales revenue:** Timing the recording of sales is something to be aware of. Generally speaking, sales revenue timing is not a serious accounting problem, but businesses should be consistent from one year to the next. However, for some businesses– such as software and other high-tech companies, and companies in their early start-up phases – the timing of recording sales revenue is a major problem. A footnote to the company's financial statements should explain its revenue recognition method if there is anything unusual about it.

Note: If products are returnable and the deal between the seller and buyer does not satisfy normal conditions for a completed sale, then recognition of sales revenue should be postponed until the return privilege no longer exists. For example, some products are sold *on approval*, which means the customer takes the product and tries it out for a few days or longer to see if they really want it. This area is increasingly significant with the continuing rapid growth of the Internet as a medium for selling. In response, the UK introduced the Distance Selling Regulations in October 2001. These regulations give consumers additional rights to obtain full refunds on goods bought over the Internet and through mail order without having to give a reason for doing so.

- **Cost of goods sold expense:** Whether to use the first-in, first-out (FIFO) method, or the last-in, first-out (LIFO) method, or the average cost method (each of which is explained in the section 'Calculating Cost of Goods Sold and Cost of Stock' later in this chapter), cost of goods sold is a big expense for companies that sell products and naturally the choice of method can have a real impact.
- **Gross margin:** Can be dramatically affected by the method used for calculating cost of goods sold expense (and the method of revenue recognition, if this is a problem).
- **Stock write-downs:** Whether to count and inspect stock very carefully to determine loss due to theft, damage and deterioration, and whether to apply the net realisable

value (NRV) method strictly or loosely are the two main questions that need to be answered. See 'Identifying Stock Losses: Net Realisable Value (NRV)' later in this chapter. Stock is a high-risk asset that's subject to theft, damage and obsolescence.

- **Bad debts expense:** When to conclude that the debts owed to you by customers who bought on credit (debtors) are not going to be paid – the question is really when to *write down* these debts (that is, remove the amounts from your asset column). You can wait until after you've made a substantial effort at collecting the debts, or you can make your decision before that time. See 'Collecting or Writing Off Bad Debts' later in this chapter.
- **Asset impairment write-downs:** Whether (and when) to *write down* or *write off* an asset – that is, remove it from the asset column. Stock shrinkage, bad debts and depreciation by their very nature are asset write-downs. Other asset write-downs are required when any asset becomes *impaired*, which means that it has lost some or all of its economic utility to the business and has little or no disposable value. An asset write-down reduces the book (recorded) value of an asset (and at the same time records an expense or loss of the same amount). A *write-off* reduces the asset's book value to zero and removes it from the accounts, and the entire amount becomes an expense or loss.

For example, your delivery truck driver had an accident. The repair of the truck was covered by insurance, so no write-down is necessary. But the products being delivered had to be thrown away and were not insured while in transit. You write off the cost of the stock lost in the accident.

- **Depreciation expense:** Whether to use a short-life method and load most of the expense over the first few years, or a longer-life method and spread the expense evenly over the years. Refer to ‘Appreciating Depreciation Methods’ later in this chapter. Depreciation is a big expense for some businesses, making the choice of method even more important.
- **Warranty and guarantee (post-sales) expenses:** Whether to record an expense for products sold with warranties and guarantees in the same period that the goods are sold (along with the cost of goods sold expense, of course) or later, when customers actually return products for repair or replacement. Businesses can usually forecast the percentage of products sold that will be returned for repair or replacement under the guarantees and warranties offered to customers – although a new product with no track record can be a problem in this regard.
- **All other SA&G expenses:** Whether to disclose separately one or more of the specific expenses included in this conglomerate total. For example, the SEC requires that *advertising* and *repairs and maintenance* expenses be disclosed in the documents businesses file with the SEC, but you hardly ever see these two expenses

reported in external profit and loss accounts. Nor do you find individual top management compensation revealed in external profit and loss accounts, other than that for directors. GAAP does not require such disclosures – much less revealing things like bribes or other legally questionable payments by a business.

- **Earnings before interest and tax (EBIT):** This profit measure equals sales revenue less all the expenses above this line; therefore, EBIT depends on the particular choices made for recording sales revenue and expenses. Having a choice of accounting methods means that an amount of wriggle is inherent in recording sales revenue and many expenses. How much wriggle effect do all these accounting choices have on the EBIT profit figure? This is a very difficult question to answer. The business itself may not know. We would guess (and it's no more than a conjecture on our part) that the EBIT for a period reported by most businesses could easily be 10–20 per cent lower or higher if different accounting choices had been made.

- **Interest expense:** Usually a cut-and-dried calculation, with no accounting problems. (Well, we can think of some really hairy interest accounting problems, but we won't go into them here.)

- **Corporation tax expense:** You can use different accounting methods for some of the expenses reported in your profit and loss account than you use for calculating taxable income. Oh, crikey! The hypothetical amount of taxable income, if the accounting methods used in the profit and loss account were used in the tax return, is calculated; then the corporation tax based on this hypothetical taxable income is figured. This is the corporation tax expense reported in the profit and loss account. This amount is reconciled with the actual amount of corporation tax owed based on the accounting methods used for tax purposes. A reconciliation of the two different tax amounts is provided in a rather technical footnote to the financial statements. See ‘Reconciling Corporation Tax’ later in this chapter.

- **Net income:** Like EBIT, can vary considerably depending on which accounting methods you use for measuring expenses. (See also Chapter 8 on *profit smoothing*, which crosses the line from choosing acceptable accounting methods into the grey area of ‘earnings management’ through means of accounting manipulation.)

Whereas bad debts, post-sales expenses and asset write-downs vary in importance from business to business, cost of goods sold and depreciation methods are so important that a business must disclose which methods it uses for these two expenses in the footnotes to its financial statements. (Chapter 8 explains footnotes to financial statements.) HM Revenue and Customs requires that a company actually record in its cost of goods sold expense and stock asset accounts the amounts determined by the accounting method they use to determine taxable income – a rare requirement in company tax law.

Considering how important the bottom-line profit number is, and that different accounting methods can cause a major difference on this all-important number, you'd think that accountants would have developed clear-cut and definite rules so that only one accounting method would be correct for a given set of facts. No such luck. The final choice boils down to an arbitrary decision, made by top-level accountants in consultation with, and with consent of, managers. If you own a business or are a manager in a business, we strongly encourage you to get involved in choosing which accounting methods to use for measuring your profit and for presenting your balance sheet. Chapter 17 explains that a manager has to answer questions about his or her financial reports on many occasions, and so should know which accounting methods are used to prepare the financial statements.

Accounting methods vary from business to business more than you'd probably suspect, even though all of them stay within the boundaries of acceptable practice. The rest of this chapter expands on the methods available for measuring certain expenses. Sales revenue accounting can be a challenge as well, but profit accounting problems lie mostly on the expense side of the ledger.

Calculating Cost of Goods Sold and Cost of Stock

One main accounting problem of companies that sell products is how to measure their *cost of goods sold expense*, which is the sum of the costs of the products sold to customers during the period. You deduct cost of goods sold from sales revenue to determine *gross margin* – the first profit line on the profit and loss account (see Chapter 5 for more about profit and loss accounts, and Figure 9-1 for a typical profit and loss account). Cost of goods sold is therefore a very important figure, because if gross margin is wrong, bottom-line profit (net income) is wrong.

> First a business acquires products, either by buying them (retailers) or by producing them (manufacturers). Chapter 12 explains how manufacturers determine product cost; for retailers product cost is simply the purchase cost. (Well, it's not entirely this simple, but you get the point.) Product cost is entered in the stock asset account and is held there until the products are sold. Then, but not before, product cost is taken out of stock and recorded in the cost of goods sold expense account. You must be absolutely clear on this point. Suppose that you clear £700 from your salary for the week and deposit this amount in your bank account. The money stays in there and is an asset until you spend it. You don't have an expense until you write a cheque.

Likewise, not until the business sells products does it have a cost of goods sold expense. When you write a cheque, you know how much it's for – you have no doubt about the amount of the expense. But when a business withdraws products from its stock and records cost of goods sold expense, the expense amount is in some doubt. The amount of expense depends on which accounting method the business selects.

The essence of this accounting issue is that you have to divide the total cost of your stock between the units sold (cost of goods sold expense, in the profit and loss account) and the unsold units that remain on hand waiting to be sold next period (stock asset, in the balance sheet).

For example, say you own a shop that sells antiques. Every time an item sells, you need to transfer the amount you paid for the item from the stock asset account into the cost of goods sold expense account. At the start of a fiscal period, your cost of goods sold expense is zero, and if you own a medium-sized shop selling medium-quality antiques, your stock asset account may be £20,000. Over the course of the fiscal period, your cost of goods sold expense should increase (hopefully rapidly, as you make many sales).

You probably want your stock asset account to remain fairly static, however. If you paid £200 for a wardrobe that sells during the period, the £200 leaves the stock asset account and finds a new home in the cost of goods sold expense account. However, you probably want to turn around and replace the item you sold, ultimately keeping your stock asset account at around the same level – although more complicated businesses have more complicated strategies for dealing with stock and more perplexing accounting problems.

You have three methods to choose from when you measure cost of goods sold and stock costs: You can follow a first-in, first-out (FIFO) cost sequence, follow a last-in, first-out cost sequence (LIFO), or compromise between the two methods and take the average costs for the period. Other methods are acceptable, but these three are the primary options. ***Caution:*** Product costs are entered in the stock asset account in the order acquired, but they are not necessarily taken out of the stock asset account in this order. The different methods refer to the order in which product costs are *taken out* of the stock asset account. You may think that only one method is appropriate – that the sequence in should be the sequence out. However, generally accepted accounting principles permit other methods.

In reality, the choice boils down to FIFO versus LIFO; the average cost method runs a distant third in popularity. If you want our opinion, FIFO is better than LIFO for reasons that we explain in the next two sections. You may not agree, and that's your right. For your business, you make the call.

The FIFO method

With the FIFO method, you charge out product costs to cost of goods sold expense in the chronological order in which you acquired the goods. The procedure is that simple. It's like the first people in line to see a film get in the cinema first. The usher collects the tickets in the order in which they were bought.

We think that FIFO is the best method for both the expense and the asset amounts. We hope that you like this method, but also look at the LIFO method before making up your mind. You should make up your mind, you know. Don't just sit on the sidelines. Take a stand.

Suppose that you acquire four units of a product during a period, one unit at a time, with unit costs as follows (in the order in which you acquire the items): £100, £102, £104 and £106. By the end of the period, you have sold three of those units. Using FIFO, you calculate the cost of goods sold expense as follows:

£100 + £102 + £104 = £306

In short, you use the first three units to calculate cost of goods sold expense. (You can see the benefit of having such a standard method if you sell hundreds or thousands of different products.)

The ending stock asset, then, is £106, which is the cost of the most recent acquisition. The £412 total cost of the four units is divided between the £306 cost of goods sold expense for the three units sold and the £106 cost of the one unit in ending stock. The total cost has been taken care of; nothing fell between the cracks.

FIFO works well for two reasons:

- In most businesses, products actually move into and out of stock in a first-in, first-out sequence: The earlier acquired products are delivered to customers before the later acquired products are delivered, so the most recently purchased products are the ones still in ending stock to be delivered in the future. Using FIFO, the stock asset reported on the balance sheet at the end of the period reflects the most recent purchase cost and therefore is close to the current *replacement cost* of the product.

- When product costs are steadily increasing, many (but not all) businesses follow a first-in, first-out sales price strategy and hold off on raising sales prices as long as possible. They delay raising sales prices until they have sold all lower-cost products. Only when they start selling from the next batch of products, acquired at a higher cost, do they raise sales prices. We strongly favour using the FIFO cost of goods sold expense method when the business follows this basic sales pricing policy because both the expense and the sales revenue are better matched for determining gross margin.

The LIFO method

Remember the cinema usher we mentioned earlier? Think about that usher going to the *back* of the line of people waiting to get into the next showing and letting them in from the rear of the line first. In other words, the later you bought your ticket, the sooner you get into the cinema. This is the LIFO method, which stands for *last-in, first-out*. The people in the front of the queue wouldn't stand for it, of course, but the LIFO method is quite acceptable for determining the cost of goods sold expense for products sold during the period. The main feature of the LIFO method is that it selects the *last* item you purchased first and then works backward until you have the total cost for the total number of units sold during the period. What about the ending stock, the products you haven't sold by the end of the year? Using the LIFO method, you never get back to the cost of the first products acquired (unless you sold out your entire stock); the earliest cost remains in the stock asset account.

Using the same example from the preceding section, assume that the business uses the LIFO method instead of FIFO. The four units, in order of acquisition, had costs of £100, £102, £104, and £106. If you sell three units during the period, LIFO gives you the following cost of goods sold expense:

£106 + £104 + £102 = £312

The ending stock cost of the one unit not sold is £100, which is the oldest cost. The £412 total cost of the four units acquired less the £312 cost of goods sold expense leaves £100 in the stock asset account. Determining which units you actually delivered to customers is irrelevant; when you use the LIFO method, you always count backward from the last unit you acquired.

If you really want to argue in favour of using LIFO – and we have to tell you that we won't back you up on this one – here's what you can say:

- Assigning the most recent costs of products purchased to the cost of goods sold expense makes sense because you have to replace your products to stay in business and the most recent costs are closest to the amount you will have to pay to replace your products. Ideally, you should base your sales prices not on original cost but on the cost of replacing the units sold.

- During times of rising costs, the most recent purchase cost maximises the cost of goods sold expense deduction for determining taxable income, and thus minimises the taxable income. In fact, LIFO was invented for income tax purposes. True, the cost of stock on the ending balance sheet is lower than recent acquisition costs, but the profit and loss account effect is more important than the balance sheet effect.

The more product cost you take out of the stock asset to charge to cost of goods sold expense, the less product cost you have in the ending stock. In maximising cost of goods sold expense, you minimise the stock cost value.

But here are the reasons why LIFO, in our view, is usually the wrong choice (the following sections of this chapter go into more details about these issues):

- Unless you base your sales prices on the most recent purchase costs or you raise sales prices as soon as replacement costs increase – and most businesses don't follow either of these pricing policies – using LIFO depresses your gross margin and, therefore, your bottom-line net income.
- The LIFO method can result in an ending stock cost value that's seriously out-of-date, especially if the business sells products that have very long lives.

- Unscrupulous managers can use the LIFO method to manipulate their profit figures if business isn't going well. Refer to 'Manipulating LIFO stock levels to give profit a boost' later in the chapter.

Note: In periods of rising product costs, it's true that FIFO results in higher taxable income than LIFO does – something you probably want to avoid, we're sure. Nevertheless, even though LIFO may be preferable in some circumstances, we still say that FIFO is the better choice in the majority of situations, for the reasons discussed earlier, and you may come over to our way of thinking after reading the following sections. By the way, if the products are intermingled such that they cannot be identified with particular purchases, then the business has to use FIFO for its income tax returns.

The greying of LIFO stock cost

If you sell products that have long lives and for which your product costs rise steadily over the years, using the LIFO method has a serious impact on the ending stock cost value reported on the balance sheet and can cause the balance sheet to look misleading. Over time, the cost of replacing products becomes further and further removed from the LIFO-based stock costs. Your 2012 balance sheet may very well report stock based on 1985, 1975 or 1965 product costs. As a matter of fact, the product costs used to value stock can go back even further.

Suppose that a major manufacturing business has been using LIFO for more than 45 years. The products that this business manufactures and sells have very long lives – in fact, the business has been making and selling many of

> the same products for many years. Believe it or not, the difference between its LIFO and FIFO cost values for its ending stock is about £2 billion because some of the products are based on costs going back to the 1950s, when the company first started using the LIFO method. The FIFO cost value of its ending stock is disclosed in a footnote to its financial statements; this disclosure is how you can tell the difference between a business's LIFO and FIFO cost values. The gross margin (before income tax) over the business's 45 years would have been £2 billion higher if the business had used the FIFO method – and its total taxable income over the 45 years would have been this much higher as well.

Of course, the business's income taxes over the years would have been correspondingly higher as well. That's the trade-off.

Note: A business must disclose the difference between its stock cost value according to LIFO and its stock cost value according to FIFO in a footnote on its financial statements – but, of course, not too many people outside of stock analysts and professional investment managers read footnotes. Business managers get involved in reviewing footnotes in the final steps of getting annual financial reports ready for release (refer to Chapter 8). If your business uses FIFO, your ending stock is stated at recent acquisition costs, and you do not have to determine what the LIFO value may have been. Annual financial reports do not disclose the estimated LIFO cost value for a FIFO-based stock.

Many products and raw materials have very short lives; they're regularly replaced by new models (you know, with those 'New and Improved!' labels) because of the latest technology or marketing wisdom. These products aren't around long enough to develop a wide gap between LIFO and FIFO, so the accounting choice between the two methods doesn't make as much difference as with long-lived products.

Manipulating LIFO stock levels to give profit a boost

The LIFO method opens the door to manipulation of profit – not that you would think of doing this, of course. Certainly, most of the businesses that choose LIFO do so to minimise current taxable income and delay paying taxes on it as long as possible – a legitimate (though perhaps misguided in some cases) goal. However, some unscrupulous managers know that they can use the LIFO method to 'create' some profit when business isn't going well.

So if a business that uses LIFO sells more products than it purchased (or manufactured) during the period, it has to reach back into its stock account and pull out older costs to transfer to the cost of goods sold expense. These costs are much lower than current costs, leading to an artificially low cost of goods sold expense, which in turn leads to an artificially high gross margin figure. This dipping into old cost layers of LIFO-based stock is called a *LIFO liquidation gain.*

This unethical manipulation of profit is possible for businesses that have been using LIFO for many years and have stock cost values far lower than the current purchase or manufacturing costs of products. By not replacing all the quantities sold, they let stock fall below normal levels.

Suppose that a retailer sold 100,000 units during the year and normally would have replaced all units sold. Instead, it purchased only 90,000 replacement units. Therefore, the other 10,000 units were taken out of stock, and the accountant had to reach back into the old cost layers of stock to record some of the cost of goods sold expense. To see the impact of LIFO liquidation gain on the gross margin, check out what the gross margin would look like if this business had replaced all 100,000 units versus the gross margin for replacing only 90,000. In this example, the old units in stock carry a LIFO-based cost of only £30, whereas the current purchase cost is £65. Assume that the units have a £100 price tag for the customer.

Gross margin if the business replaced all 100,000 of the units sold

Sales revenue (100,000 units at £100 per unit)	£10,000,000
Cost of goods sold expense (100,000 units at £65 per unit)	6,500,000
Gross margin	£3,500,000

Gross margin if the business replaced only 90,000 of the units sold

Sales revenue (100,000 units at £100 per unit)		£10,000,000
Cost of goods sold expense:		
Units replaced (90,000 units at £65 per unit)		£5,850,000
Units from stock (10,000 units at £30 per unit)	300,000	6,150,000
Gross margin		£3,850,000

The LIFO liquidation gain (the difference between the two gross margins) in this example is £350,000 – the £35 difference between the old and the current unit costs multiplied by 10,000 units. Just by ordering fewer replacement products, this business padded its gross margin – but in a very questionable way.

Of course, this business may have a good, legitimate reason for trimming stock by 10,000 units – to reduce the capital invested in that asset, for example, or to anticipate lower sales demand in the year ahead. LIFO liquidation gains may also occur when a business stops selling a product and that stock drops to zero. Still, we have to warn investors that when you see a financial statement reporting a dramatic decrease in stock and the business uses the LIFO method, you should be aware of the possible profit manipulation reasons behind the decrease.

Note: A business must disclose in the footnotes to its financial statements any substantial LIFO liquidation gains that occurred during the year. The outside auditor should make sure that the company includes this disclosure. (Chapter 15 discusses audits of financial statements by auditors.)

The average cost method

Although not nearly as popular as the FIFO and LIFO methods, the average cost method seems to offer the best of both worlds. The costs of many things in the business world fluctuate; business managers focus on the average product cost over a time period. Also, the averaging of product costs over a period of time has a desirable smoothing effect that prevents cost of goods sold from being overly dependent on wild swings of one or two purchases.

To many businesses, the compromise aspect of the method is its *worst* feature. Businesses may want to go one way or the other and avoid the middle ground. If they want to minimise taxable income, LIFO gives the best effect during times of rising prices. Why go only halfway with the average cost method? Or if the business wants its ending stock to be as near to current replacement costs as possible, FIFO is better than the average cost method. Even using computers to keep track of averages, which change every time product costs change, is a nuisance. No wonder the average cost method is not popular! But it *is* an acceptable method.

Identifying Stock Losses: Net Realisable Value (NRV)

Regardless of which method you use to determine stock cost, you should make sure that your accountants apply the *net realisable value (NRV)* test to stock. (Just to confuse you, this test is sometimes called the *lower of cost or market (LCM)* test.) A business should go through the NRV routine at least once a year, usually near or at year-end. The process consists of comparing the cost of every product in stock – meaning the cost that's recorded for each product in the stock asset account according to the FIFO or LIFO method (or whichever method the company uses) – with two benchmark values:

- The product's *current replacement cost* (how much the business would pay to obtain the same product right now).
- The product's *net realisable value* (how much the business can sell the product for).

If a product's cost on the books is higher than either of these two benchmark values, your accountant should decrease product cost to the lower of the two. In other words, stock losses are recognised *now* rather than *later*, when the products are sold. The drop in the replacement cost or sales value of the product should be recorded now, on the theory that it's better to take your medicine now than to put it off. Also, the stock cost value on the balance sheet is more conservative because stock is reported at a lower cost value.

Buying and holding stock involves certain unavoidable risks. Asset write-downs, explained in the 'Decision-Making behind the Scenes in Profit and Loss Accounts' section of this chapter, are recorded to recognise the consequences of two of those risks – stock shrinkage and losses to natural disasters not fully covered by insurance. NRV records the losses from two other risks of holding stock:

- **Replacement cost risk:** After you purchase or manufacture a product, its replacement cost may drop permanently below the amount you paid (which usually also affects the amount you can charge customers for the products, because competitors will drop their prices).
- **Sales demand risk:** Demand for a product may drop off permanently, forcing you to sell the products below cost just to get rid of them.

Determining current replacement cost values for every product in your stock isn't easy! Applying the NRV test leaves much room for interpretation.

Keeping accurate track of your stock costs is important to your bottom line both now and in the future, so don't fall into the trap of doing a quick NRV scan and making a snap judgment that you don't need a stock write-down.

Some shady characters abuse NRV to cheat on their company tax returns. They *write down* their ending stock cost value – decrease ending stock cost more than can be justified by the NRV test – to increase the deductible expenses on their tax returns and thus decrease taxable income. A product may have a proper cost value of £100, for example, but a shady character may invent some reason to lower it to £75 and thus record a £25 stock write-down expense in this period for each unit – which is not justified by the facts. But, even though the person can deduct more this year, he or she will have a lower stock cost to deduct in the future. Also, if the person is selected for an HM Revenue and Customs audit and the tax inspectors discover an unjustified stock write-down, the person may end up being charged with tax evasion.

Most accounting software packages either support or have plug-in modules that allow you to run all these costing methods and compare their effect on your apparent financial performance. For example, the Sage Pro Inventory Control module (check out their website at www.sageproerp.com/products/accounting/ic) supports LIFO, FIFO, average weighted and standard cost inventory valuation methods.

Managing Your Stock Position

Businesses have to carry a certain minimum amount of stock to ensure the production pipeline works efficiently and likely demand is met. So the costs associated with ordering large quantities infrequently and so reducing the order cost but increasing the cost of holding stock has to be balanced with placing frequent orders, which pushes the cost of orders up, but reduces stock holding costs. Economic Order Quantity (EOQ) is basically an accounting formula that calculates the most cost-effective quantity to order; the point at which the combination of order costs and inventory carrying costs are at the minimum.

The formula for EOQ is:

$$\text{Economic Order Quantity} = \sqrt{\frac{(2 \times R \times O)}{C}}$$

Where: R = Annual demand in units; O = Cost of placing an order; C = Cost of carrying a unit of inventory for the year.

Appreciating Depreciation Methods

In theory, depreciation expense accounting is straightforward enough: You divide the cost of a fixed asset among the number of years that the business expects to use the asset. In other words, instead of having a huge lump-sum expense in the year that you make the purchase, you charge a fraction of the cost to expense for each year of the asset's lifetime. Using this method is much easier on your bottom line in the year of purchase, of course.

But theories are rarely as simple in real life as they are on paper, and this one is no exception. Do you divide the cost *evenly* across the asset's lifetime, or do you charge more to certain years than others? Furthermore, when it eventually comes time to dispose of fixed assets, the assets may have some disposable, or *salvage*, value. Only cost minus the salvage value should be depreciated, right? Or, should salvage value estimates be ignored and the total cost of a fixed asset be depreciated? And how do you estimate how long an asset will last in the first place? Do you consult an accountant psychic hot line?

As it turns out, HM Revenue and Customs runs its own little psychic business on the side, with a crystal ball known as the HM Revenue and Customs Code. The HM Revenue and Customs Code doesn't give you predictions of how long your fixed assets will *last*; it only tells you what kind of timeline to use for income tax purposes, as well as how to divide the cost along that timeline. HM Revenue and Customs have a little help in their psychic predictions. They have a direct line to their boss, the Chancellor of the Exchequer, who varies these rules every year or so to stimulate capital spending by businesses. This is done by varying the *writing down allowance*, which is tax speak for the amount of depreciation expense you can get tax relief for. So if the Chancellor wants to encourage businesses to buy computers, he can set a 100 per cent writing down allowance for the first year, whereas the asset may well have an economic life of three years or more. Confused? Well at least you know what you are getting for your money when you hire a tax accountant.

Hundreds of books have been written on depreciation, but the only book that counts is the HM Revenue and Customs Code. Most businesses adopt the useful lives allowed by the income tax law for their financial statement accounting; they don't go to the trouble of keeping a second depreciation schedule for financial reporting. Why complicate things if you don't have to? Why keep one depreciation schedule for income tax and a second for preparing your financial statements? However, they do tell you what their policy is.

Tesco's annual report contains this explanation of their depreciation policy:

Depreciation is provided on a straight-line basis over the anticipated useful economic lives of the assets. The following rates applied for the Group and are consistent with the prior year:

- Land premiums paid in excess of the alternative use value – at 2.5 per cent of cost.
- Freehold and leasehold buildings with greater than 40 years unexpired – at 2.5 per cent of cost.
- Leasehold properties with less than 40 years unexpired are amortised by equal annual instalments over the unexpired period of the lease.
- Plant, equipment, fixtures and fittings, and motor vehicles – at rates varying from 10 per cent to 33 per cent.

By the way, keeping two depreciation schedules is an example of *keeping two sets of books*. In some situations a person using this term is referring to the illegal tactic of keeping one set of accounts for the actual amounts of sales revenue and expenses and keeping a second set of fictional accounts for income tax purposes. (We've never seen two sets of books in actual practice – although, we have seen cases of skimming sales revenue and inflating expenses on the books to minimise the taxable income of a business.)

Note: Taxation laws can change at any time and can get extremely technical. Please use the following information for a basic understanding of the procedures and *not* as tax advice. There are a number of annual income tax guides, such as *Tolley's Tax Guides*, published by Butterworths.

HM Revenue and Customs' rules give guidance on which of two depreciation methods to use for particular types of assets:

- **Straight-line depreciation method:** With this method, you divide the cost evenly among the years of the asset's estimated lifetime. So if a new building owned and used by a business costs £390,000 and its useful life is 39 years, the depreciation expense is £10,000 (1/39 of the cost) for each of the 39 years. (See the example of Tesco above.) You must use straight-line depreciation for buildings and may choose to use it for other types of assets; once you start using this method for a particular asset, you can't change your mind and switch to another method later.
- **Accelerated depreciation method:** Actually, this term is a generic catch-all for several different kinds of methods. What they all have in common is that they're *front-loading* methods, meaning that you charge a larger amount of depreciation expense in the early years and a smaller amount in the later years. *Accelerated depreciation method* also refers to adopting useful lives that are shorter than realistic estimates (very few cars are useless after five years, for example, but they can be fully depreciated over five years).

  One popular accelerated method is the *double-declining balance* (DDB) depreciation method. With this method, you calculate the straight-line depreciation rate and then you double that percentage. You apply that doubled percentage to the declining balance over the course of the asset's depreciation time line. After a certain number of years, you switch back to the straight-line method for the remainder of the asset's depreciation years to ensure that you depreciate the full cost by the end of the predetermined number of years. See the sidebar 'The double-declining balance depreciation method' for an example.

TIP

By the way, the salvage value of fixed assets (the estimated disposal values when the assets are taken to the junkyard or sold off at the end of their useful lives) is ignored in the calculation of depreciation for income tax. Put another way, if a fixed asset is held to the end of its entire depreciation life, then its original cost will be fully depreciated, and the fixed asset from that time forward will have a zero book value. (Recall that book value is equal to the cost minus the balance in the accumulated depreciation account.) Fully depreciated fixed assets are grouped with all other fixed assets in external balance sheets. All these long-term resources of a business are reported in one asset account called *property, plant and equipment* (instead of fixed assets). If all its fixed assets were fully depreciated, the balance sheet of a company would look rather peculiar – the cost of its fixed assets would be completely offset by its accumulated depreciation. We've never seen this, but it would be possible for a business that hasn't replaced any of its fixed assets for a long time.

The straight-line method has strong advantages: It's easy to understand and it stabilises the depreciation expense from year to year. But many business managers and accountants favour the accelerated depreciation method. Keep in mind, however, that the depreciation expense in the annual profit and loss account is higher in the early years when you use an accelerated depreciation method, and so bottom-line profit is lower until later years. Nevertheless, many accountants and businesses like accelerated depreciation because it paints a more conservative (a lower, or a more moderate) picture of profit performance in the early years. Who knows? Fixed assets may lose their economic usefulness to a business sooner than expected. If this happens, using the accelerated depreciation method would look good in hindsight.

Minimising taxable income and corporation tax in the early years to hang on to as much cash as possible is very important to many businesses, and they pay the price of reporting lower net income in order to defer paying corporation tax as long as possible. Or they may use the straight-line method in their financial statements even though they use an accelerated method in their annual tax returns, which complicates matters. (Refer to the section ‘Reconciling Corporation Tax’ for more information.)

REAL WORLD EXAMPLE

The double-declining balance depreciation method

Suppose that a business pays £100,000 for a fixed asset that has a five-year useful life and for which the double-declining balance depreciation method is used. The annual depreciation expense by the straight-line method is 1⁄5, or 20 per cent, of cost per year – which in this example would be £20,000 per year. With the DDB method, you double that percentage to 40 per cent, which gives £40,000 depreciation for the first year. After the first year, however, the 40 per cent rate of depreciation is applied to the declining balance of the fixed asset. For example, in the second year, depreciation equals the £60,000 non-depreciated balance of the fixed asset (£100,000 cost less the £40,000 first year depreciation) multiplied by the 40 per cent rate – which gives £24,000 depreciation for the second year. The third year's depreciation is 40 per cent of £36,000 (£100,000 cost minus the £64,000 accumulated depreciation balance).

You then switch to the straight-line method on the remaining amount of non-depreciated cost for the last two years in this example (the exact number of years depends on the number of years in the asset's depreciation timeline) – meaning that you divide the remaining balance by the number of remaining years. In this example, you need to use the straight-line method after the third year because if you applied the 40 per cent rate to the non-depreciated balance of the fixed asset at the start of the fourth year and again in the following year on the declining balance, the fixed asset's cost would not be completely depreciated by the end of five years.

Got all that? Good, because things get even more technical and complicated in company tax law. For example, businesses that buy fixed assets in the later part of a year must follow the *half-year* convention, which requires that the business use a midpoint date in the year that an asset is acquired and placed in service. We don't want to get into all the details here; suffice it to say that you need a good tax-law accountant to get the most out of your depreciation expense deduction.

TIP

Except for brand-new enterprises, a business typically has a mix of fixed assets – some in their early years of depreciation, some in their middle years and some in their later years. So, the overall depreciation expense for the year may not be that different than if the business had been using straight-line depreciation for all its fixed assets.

A business does *not* have to disclose in its external financial report what its depreciation expense would have been if it had been using an alternative method. Readers of the financial statements cannot tell how much difference the choice of depreciation method made in that year.

Collecting or Writing Off Bad Debts

A business that allows its customers to pay on credit granted by the business is always subject to *bad debts* – debts that some customers never pay off. You are allowed, provided that you demonstrate serious efforts to recover the money owed, to write the loss in value off against your tax bill. You may also recover any VAT paid in respect of the invoice concerned. Don't forget in your role as an unpaid tax collector you will have charged your defaulting customer Value-Added Tax, paid that over to HM Revenue and Customs as required, but failed to recover the loot from the said customer, along with the rest of the boodle owed.

Reconciling Corporation Tax

Corporation tax is a heavy influence on a business's choice of accounting methods. Many a business decides to minimise its current taxable income by recording the maximum amount of deductible expenses. Thus, taxable income is lower, corporation tax paid to the Treasury is lower and the business's cash balance is higher. Using these expense maximisation methods to prepare the profit and loss account of the business has the obvious effect of minimising the profit that's reported to the owners of the business. So, you may ask whether you can use one accounting method for corporation tax but an alternative method for preparing your financial statements. Can a business eat its cake (minimise corporation tax) and have it too (report more profit in its profit and loss account)?

The answer is yes, you can. You may decide, however, that using two different accounting methods is not worth the time and effort. In other areas of accounting for profit, businesses use one method for income tax and an alternative method in the financial statements (but we don't want to go into the details here).

When recording an expense, either an asset is decreased or a liability is increased. In this example, a special type of liability is increased to record the full amount of corporation tax expense: *deferred tax payable*. This unique liability account recognises the special contingency hanging over the head of the business to anticipate the time in the future when the business exhausts the higher depreciation amounts deducted in the early years by accelerated depreciation, and moves into the later years when annual depreciation amounts are less than amounts by the straight-line depreciation method. This liability account does not bear interest. Be warned that the accounting for this liability can get very complicated. The business provides information about this liability in a footnote to its financial statements, as well as reconciling the amount of corporation tax expense reported in its profit and loss account with the tax owed the government based on its tax return for the year. These footnotes are a joy to read – just kidding.

Dealing With Foreign Exchange

Foreign exchange poses a tricky problem when it comes to accounting reports. Currencies just aren't stable and they certainly don't respect year-end. A business can have all sorts of currency swishing around, pounds, dollars, euros, yen . . . You need to include a note in your accounts to explain the extent of your use of foreign exchange and the way in which you've handled the conversion of currencies. In this section I explain three areas to pay particular attention to.

Transaction exposure

Transaction exposure occurs when a business incurs costs or generates revenues in any currency other than the one shown in its filed accounts. Two types of event can lead to this:

- A mismatch between cost of sales (manufacturing and so on) incurred in one currency and the actual sales income generated in another.
- A time lag between setting the selling price in one currency and the date the customer actually pays up.

As exchange rates frequently change, you need to explain how you handled the conversions.

Translation exposure

Translation exposure refers to the effects of movements in the exchange rate on the balance sheet and profit and loss account that occur between reporting dates on assets and liabilities denominated in foreign currencies. In practice, any company that has assets or liabilities denominated in a currency other than the currency shown on their reported accounts has to 'translate' those back into the company's reporting currency when the consolidated accounts have to be produced. This can be up to four times a year for major trading businesses. Any changes in the foreign exchange rate between the countries involved cause movements in the accounts.

Comparing performance

Exchange rate movements can make it difficult to compare one year with another; an essential accounting task if management is to keep track of how a business is performing. For example, if a UK company sold 1,000 of its products into a eurozone country, its selling price expressed in pounds sterling could be as much as ten percent higher or lower (a euro was anything from 80.68p to 90.43p in the most recent 52-week period while we prepared this edition).

Accountants usually handle this movement by stating that current year revenue is compared to the prior financial year, translated on consistent exchange rates to eliminate distortions due to fluctuations in exchange rates. In any event, you need to include a note in the accounts showing how you've handled currency movements.

Two Final Issues to Consider

We think that you have been assuming all along that *all* expenses should be recorded by a business. Of course, you're correct on this score. Many accountants argue that two expenses, in fact, are not recorded by businesses, but should be. A good deal of controversy surrounds both items. Many think one or both expenses should be recognised in measuring profit and in presenting the financial statements of a business:

- **Share options:** As part of their compensation packages, many public companies award their high-level executives share options, which give them the right to buy a certain number of shares at fixed prices after certain conditions are satisfied (years of service and the like). If the market price of the company's shares in the future rises above the exercise (purchase) prices of the share options – assuming the other conditions of these contracts are satisfied – the executives use their share options to buy shares below the going market price of the shares.

  Should the difference between the going market price of the shares and the exercise prices paid for the shares by the executives be recognised as an expense? Generally accepted accounting principles (GAAP) do not require that such an expense be recorded (unless the exercise price was below the market price at the time of granting the share option). However, the business must present a footnote disclosing the number of shares and exercise prices of its stock options, the theoretical cost of the share options to the business, and the dilution effect on earnings per share that exercising the share options will have. But this is a far cry from recording an expense in the profit and loss account. Many persons, including Warren Buffett, who is Chair of Berkshire Hathaway, Inc, are strongly opposed to share options – thinking that the better alternative is to pay the executives in cash and avoid diluting earnings per share, which depresses the market value of the shares.

  In brief, the cost to shareholders of share options is off the books. The dilution in the market value of the shares of the corporation caused by its share options is suffered by the shareholders, but does not flow through the profit and loss account of the business.

- **Purchasing power of pound loss caused by inflation:** Due to inflation, the purchasing power of one pound today is less than it was one year ago, two years ago and so on back in time. Yet accountants treat all pounds the same, regardless of when the pound amounts were recorded on the books. The cost balance in a fixed asset account (a building, for instance) may have been recorded 10 or 20 years ago; in contrast, the cost balance in a current asset account (stock, for instance) may have been recorded only one or two months ago (assuming the business uses the FIFO method). So, depreciation expense is based on very old pounds that had more purchasing power back then, and cost of goods sold expense is based on current pounds that have less purchasing power than in earlier years.

Stay tuned for what might develop in the future regarding these two expenses. If we had to hazard a prediction, we would say that the pressure for recording the expense of share options will continue and might conceivably succeed – although we would add that powerful interests oppose recording share options expense. On the other hand, the loss of purchasing power of the pound caused by inflation has become less important in an era signified by low inflation rates around the world. However, an enormous increase in the rate of inflation would resurrect this argument, and with rates of 5 per cent and more prevailing in some parts of 'new' Europe, 7 per cent in India, 10 per cent in Russia and 11 per cent in Turkey, the beast is not quite as dead as economists would like us to believe.

Part IV
Financial Reports in the Outside World

'Oh no! Not another bad company financial report.'

In this part . . .

This part looks at accounting and financial reporting from the outside investor's, or non-manager's point of view. Outside investors in a business – the owners who are not on the inside managing the business – depend on the financial reports from the business as their main source of information about the business. Investors should know how to read and interpret the financial statements and what to look for in the footnotes to the statements. Their main concerns are the business's profit and cash flow performance and its financial health. Lenders to the business have similar interests in how the business is doing. Key ratios are calculated to test the success of the business in making profit and keeping its financial affairs in order. You can use the same ratios on the accounts of your competitors, customers, suppliers or potential acquisition targets to see how they're performing.

Investors should also read the independent auditor's report, which provides some, though far from conclusive, assurance that the financial statements have been prepared properly. The auditor's report may reveal serious shortcomings in the statements (if they find any), and warns investors in the event that the business is standing on thin financial ice and may not be able to continue as a going concern. Investors should also look and see from a financial perspective how comparable businesses are performing.

Chapter 14

How Investors Read a Financial Report

In This Chapter

- Looking after your investments
- Keeping financial reports private versus making them public
- Using ratios to understand profit performance
- Using ratios to interpret financial condition and cash flow
- Scanning footnotes and identifying the important ones
- Paying attention to what the auditor has to say

In reading financial reports, directors, managers, business owners and investors need to know how to navigate through the financial statements to find the vital signs of progress and problems. The financial statement ratios explained in this chapter point the way – these ratios are signposts on the financial information highway. You can also keep abreast of business affairs by reading financial newspapers and investment magazines, and investment newsletters are very popular. These sources of financial information refer to the ratios discussed in this chapter on the premise that you know what the ratios mean. Most managers or individual investors in public companies don't have the time or expertise to study a financial report thoroughly enough to make decisions based on the report, so they rely on stockbrokers, investment advisers and publishers of credit ratings (like Standard & Poor's) for interpretations of financial reports. The fact is that the folks who prepare financial reports have this kind of expert audience in mind; they don't include explanations or mark passages with icons to help *you* understand the report.

Sure you may have your own accountant or investment adviser on tap so why should you bother reading this chapter if you rely on others to interpret financial reports anyway? Well, the more you understand the factors that go into interpreting a financial report, the better prepared you are to evaluate the commentary and advice of stock analysts and other investment experts. If you can at least nod intelligently while your stockbroker talks about a business's P/E and EPS, you'll look like a savvy investor – and may get more favourable treatment. (P/E and EPS, by the way, are two of the key ratios explained later in the chapter.)

This chapter gives you the basics for comparing companies' financial reports, including the points of difference between private and public companies, the important ratios that you should know about and the warning signs to look out for on audit reports. Part II of this book explains the three primary financial statements that are the core of every financial report: the profit and loss account, the balance sheet and the cash flow statement. In this chapter, we also suggest how to sort through the footnotes that are an integral part of every financial report to identify those that have the most importance to you. Believe us, the pros read the footnotes with a keen eye.

Financial Reporting by Private versus Public Businesses

The main impetus behind the continued development of generally accepted accounting principles (GAAP) has been the widespread public ownership and trading in the securities (stocks and bonds) issued by thousands of companies. The 1929 stock market crash and its aftermath plainly exposed the lack of accounting standards, as well as many financial reporting abuses and frauds. Landmark federal securities laws were passed in the US in 1933 and 1934, and a federal regulatory agency with broad powers – the Securities and Exchange Commission (SEC) – was created and given jurisdiction over trading in corporate securities. In the UK, the Government has enacted a series of Companies Acts, culminating in one consolidated act in 2006, that have strengthened the protection for shareholders. Financial reports and other information must be filed with The London Stock Exchange or the relevant authorities elsewhere, such as the SEC in the US, and made available to the investing public.

Accounting standards are not limited to public companies whose securities are traded on public exchanges, such as the London and New York Stock Exchanges and NASDAQ. These financial accounting and reporting standards apply with equal force and authority to private businesses whose ownership shares are not traded in any open market. When the shareholders of a private business receive its periodic financial reports, they are entitled to assume that the company's financial statements and footnotes are prepared in accordance with the accounting rules in force at the time. Even following the rules leaves a fair amount of wriggle room – look back to Chapter 13 if you need a refresher on this subject. So it always pays to check over the figures yourself to be sure of what is really going on. The bare-bones content of a private business's annual financial report includes the three primary financial statements (balance sheet, profit and loss account, and cash flow statement) plus several footnotes. We've seen many private company financial reports that don't even have a letter from the chairman – just the three financial statements plus a few footnotes and nothing more. In fact, we've seen financial reports of private businesses (mostly small companies) that don't even include a cash flow statement; only the balance sheet and profit and loss account are presented. Omitting a cash flow statement violates the rules – but the company's shareholders and its lenders may not demand to see the cash flow statement, so the company can get away with it.

Publicly owned businesses must comply with an additional layer of rules and requirements that don't apply to privately owned businesses. These rules are issued by the Stock Exchange, the agency that regulates financial reporting and trading in stocks and bonds of publicly owned businesses. The Stock Exchange has no jurisdiction over private businesses; those businesses need only worry about GAAP, which don't have many hard-and-fast rules about financial report formats. Public businesses have to file financial reports and other forms with the Stock Exchange that are made available to the public. These filings are available to the public on the London Stock Exchange's website www.londonstockexchange.com/ or for US companies on the Securities Exchange Commission's (SEC's) EDGAR database at the SEC's website – www.sec.gov/edgar/quickedgar.htm.

The best known of these forms is the annual 10-K, which includes the business's annual financial statements in prescribed formats with all the supporting schedules and detailed disclosures that the SEC requires.

Here are some (but not all) of the main financial reporting requirements that publicly owned businesses must adhere to. (Private businesses may include these items as well if they want, but they generally don't.)

- **Management discussion and analysis (MD&A) section:** Presents the top managers' interpretation and analysis of a business's profit performance and other important financial developments over the year.

- **Earnings per share (EPS):** The only ratio that a public business is *required* to report, although most public businesses do report a few other ratios as well. See 'Earnings per share, basic and diluted' later in this chapter. Note that private businesses' reports generally don't include any ratios (but you can, of course, compute the ratios yourself).
- **Three-year comparative profit and loss account:** See Chapter 5 for more information about profit and loss accounts.

Note: A publicly-owned business can make the required filings with the Stock Exchange or SEC and then prepare a different annual financial report for its shareholders, thus preparing two sets of financial reports. This is common practice. However, the financial information in the two documents can't differ in any material way. A typical annual financial report to shareholders is a glossy booklet with excellent art and graphic design including high-quality photographs. The company's products are promoted and its people are featured in glowing terms that describe teamwork, creativity and innovation – we're sure you get the picture. In contrast, the reports to the London Stock Exchange or SEC look like legal briefs – nothing fancy in these filings. The core of financial statements and footnotes (plus certain other information) is the same in both the Stock Exchange filings and the annual reports to shareholders. The Stock Exchange filings contain more information about certain expenses and require much more disclosure about the history of the business, its main markets and competitors, its principal officers, any major changes on the horizon and so on. Professional investors and investment managers read the Stock Exchange filings.

Most public companies solicit their shareholders' votes in the annual election of persons to the board of directors (whom the business has nominated) and on other matters that must be put to a vote at the annual shareholders' meeting. The method of communication for doing so is called a *proxy statement* – the reason being that the shareholders give their votes to a *proxy*, or designated person, who actually casts the votes at the annual meeting. The Stock Exchange requires many disclosures in proxy statements that are not found in annual financial reports issued to shareholders or in the business's annual accounts filed at Companies House. For example, compensation paid to the top-level officers of the business must be disclosed, as well as their shareholdings. If you own shares in a public company, take the time to read through all the financial statements you receive through the post and any others you can get your hands on.

Analysing Financial Reports with Ratios

Financial reports have lots of numbers in them. (Duh!) The significance of many of these numbers is not clear unless they are compared with other numbers in the financial statements to determine the relative size of one number to another number. One very useful way of interpreting financial reports is to compute *ratios* – that is, to divide a particular number in the financial report by another. Financial report ratios are also useful because they enable you to compare a business's current performance with its past performance or with another business's performance, regardless of whether sales revenue or net income was bigger or smaller for the other years or the other business. In other words, using ratios cancels out size differences.

The following sections explain the ten financial statement ratios that you're most likely to run into. Here's a general overview of why these ratios are important:

- **Gross margin ratio and profit ratio:** You use these ratios to measure a business's profit performance with respect to its sales revenue. Sales revenue is the starting point for making profit; these ratios measure the percentage of total sales revenue that is left over as profit.
- **Earnings per share (EPS), price/earnings (P/E) ratio and dividend yield:** These three ratios revolve around the market price of shares, and anyone who invests in publicly owned businesses should be intimately familiar with them. As an investor, your main concern is the return you receive on your invested capital. Return on capital consists of two elements:
  - Periodic **cash dividends** distributed by the business.
  - Increase (or decrease) in the **market price** of the shares.

  Dividends and market prices depend on earnings – and there you have the relationship among these three ratios and why they're so important to you, the investor. Major newspapers report P/E ratios and dividend yields in their stock market activity tables; stockbrokers' investment reports focus mainly on forecasts of EPS and dividend yield.

- **Book value per share and return on equity (ROE):** Shares for private businesses have no ready market price, so investors in these businesses use the ROE ratio, which is based on the value of their ownership equity reported in the balance sheet, to measure investment performance. Without a market price for the shares of a private business, the P/E ratio cannot be determined. EPS can easily be determined for a private business but does not have to be reported in its profit and loss account.
- **Current ratio and acid-test ratio:** These ratios indicate whether a business should have enough cash to pay its liabilities.
- **Return on assets (ROA):** This ratio is the first step in determining how well a business is using its capital and whether it's earning more than the interest rate on its debt, which causes financial leverage gain (or loss).

The profit and loss account and balance sheet of the business example that we first use in Chapter 8 are repeated here so that you have a financial statement for reference – see Figures 14-1 (profit and loss account) and 14-2 (balance sheet). Notice that a cash flow statement is not presented here – mainly because no ratios are calculated from data in the cash flow statement. (Refer to the sidebar 'The temptation to compute cash flow per share: Don't give in!') The footnotes to the company's financial statements are not presented here, but the use of footnotes is discussed in the following sections.

Figure 14-1: A sample profit and loss account.

(Amounts in thousands, except per share amounts)	
Profit and Loss Account for Year	
Sales Revenue	£ 52,000
Cost of Goods Sold Expense	31,200
Gross Margin	£ 20,800
Sales, Administration, and General Expenses	15,600
Depreciation Expense	1,650
Earnings Before Interest and Tax	£ 3,550
Interest Expense	750
Earnings Before Tax	£ 2,800
Corporation Tax Expense	900
Net Income	£ 1,900
Earnings Per Share	£ 2.39

Figure 14-2: A sample balance sheet.

(Amounts in thousands)		
Balance Sheet at End of Year		
Assets		
Cash	£ 3,500	
Debtors	5,000	
Stock	7,800	
Prepaid Expenses	900	
Current Assets		£ 17,200
Fixed Assets	£ 19,500	
Accumulated Depreciation	(6,825)	12,675
Total Assets		£ 29,875
Liabilities		
Creditors	£ 1,500	
Accrued Expenses Payable	2,400	
Tax Payable	75	
Overdraft	4,000	
Current Liabilities		£ 7,975
Long-term Loans		6,000
Owners' Equity		
Share Capital (795,000 shares)	£ 4,000	
Retained Earnings	11,900	15,900
Total Liabilities and Owners' Equity		£ 29,875

Gross margin ratio

Making bottom-line profit begins with making sales and earning enough gross margin from those sales, as explained in Chapters 5 and 9. In other words, a business must set its sales prices high enough over product costs to yield satisfactory gross margins on its products, because the business has to worry about many more expenses of making sales and running the business, plus interest expense and income tax expense. You calculate the *gross margin ratio* as follows:

Gross margin ÷ sales revenue = gross margin ratio

So a business with a £20.8 million gross margin and £52 million in sales revenue (refer to Figure 14-1) ends up with a 40 per cent gross margin ratio. Now, if the business had only been able to earn a 41 per cent gross margin, that one additional point (one point is 1 per cent) would have caused a jump in its gross margin of £520,000 (1 per cent × £52 million sales revenue) – which would have trickled down to earnings before income tax. Earnings before income tax would have been 19 per cent higher (a £520,000 bump in gross margin ÷ £2.8 million income before income tax). Never underestimate the impact of even a small improvement in the gross margin ratio!

Outside investors know only the information disclosed in the external financial report that the business releases. They can't do much more than compare the gross margin for the two- or three-yearly profit and loss accounts included in the annual financial report. Although publicly owned businesses are required to include a management discussion and analysis (MD&A) section that should comment on any significant change in the gross margin ratio, corporate managers have wide latitude in deciding what exactly to discuss and how much detail to go into. You definitely should read the MD&A section, but it may not provide all the answers you're looking for. You have to search further in stockbroker releases, in articles in the financial press, or at the next professional business meeting you attend.

As explained in Chapter 9, managers focus on *contribution margin per unit* and *total contribution margin* to control and improve profit performance business. Contribution margin equals sales revenue minus product cost and other variable operating expenses of the business. Contribution margin is profit before the company's total fixed costs for the period are deducted. Changes in the contribution margins per unit of the products sold by a business and changes in its total fixed costs are extremely important information in managing profit.

However, businesses do not disclose contribution margin information in their *external* financial reports – they wouldn't even think of doing so. This information is considered to be proprietary in nature; it should be kept confidential and out of the hands of its competitors. In short, investors do not have access to information about the business's contribution margin.

Neither accounting standards nor the Stock Exchange requires that such information be disclosed. The external profit and loss account discloses gross margin and operating profit, or earnings before interest and income tax expenses. However, the expenses between these two profit lines in the profit and loss account are not separated between variable and fixed (refer to Figure 14-1).

Profit ratio

Business is motivated by profit, so the *profit ratio* is very important to say the least. The profit ratio indicates how much net income was earned on each £100 of sales revenue:

Net income ÷ sales revenue = profit ratio

For example, the business in Figure 14-1 earned £1.9 million net income from its £52 million sales revenue, so its profit ratio is 3.65 per cent, meaning that the business earned £3.65 net income for each £100 of sales revenue.

A seemingly small change in the profit ratio can have a big impact on the bottom line. Suppose that this business had earned a profit ratio of 5 per cent instead of 3.65 per cent. That increase in the profit ratio translates into a £700,000 increase in bottom-line profit (net income) on the same sales revenue.

Profit ratios vary widely from industry to industry. A 5–10 per cent profit ratio is common in most industries, although some high-volume retailers, such as supermarkets, are satisfied with profit ratios around 1 per cent or 2 per cent.

You can turn any ratio upside down and come up with a new way of looking at the same information. If you flip the profit ratio over to be sales revenue divided by net income, the result is the amount of sales revenue needed to make £1 profit. Using the same example, £52 million sales revenue ÷ £1.9 million net income = 27.37 to 1 upside-down profit ratio, which means that this business needs £27.37 in sales to make £1 profit. So you can say that net income is 3.65 per cent of sales revenue, or you can say that sales revenue is 27.37 times net income – but the standard profit ratio is expressed as net income divided by sales revenue.

Earnings per share, basic and diluted

Publicly owned businesses, according to generally accepted accounting principles (GAAP), must report *earnings per share (EPS)* below the net income line in their profit and loss accounts – giving EPS a certain distinction among the ratios. Why is EPS considered so important? Because it gives investors a means of determining the amount the business earned on their share investments: EPS tells you how much net income the business earned for each share you own. The essential equation for EPS is as follows:

Net income ÷ total number of capital stock shares = EPS

For the example in Figures 14-1 and 14-2, the company's £1.9 million net income is divided by the 795,000 shares of stock the business has issued to compute its £2.39 EPS.

Note: Private businesses do not have to report EPS if they don't want to. Considering the wide range of issues covered by GAAP, you find surprisingly few distinctions between private and public businesses – these authoritative accounting rules apply to all businesses. But EPS is one area where GAAP makes an exception for privately owned businesses. EPS is extraordinarily important to the shareholders of businesses whose shares are publicly traded. These shareholders focus on market price *per share*. They want the total net income of the business to be communicated to them on a per share basis so that they can easily compare it with the market price of their shares. The shares of privately owned companies are not actively traded, so there is no readily available market value for their shares. The thinking behind the rule that privately owned businesses should not have to report EPS is that their shareholders do not focus on per share values and are more interested in the business's total net income performance.

The business in the example is too small to be publicly owned. So we turn here to a larger public company example. This publicly owned company reports that it earned $1.32 billion net income for the year just ended. At the end of the year, this company has 400 million shares *outstanding*, which refers to the number of shares that have been issued and are owned by its shareholders. Thus, its EPS is $3.30 ($1.32 billion net income ÷ 400 million stock shares). But here's a complication: The business is committed to issuing additional capital shares in the future for share options that the company has granted to its managers, and it has borrowed money on the basis of debt instruments that give the lenders the right to convert the debt into its capital stock. Under terms of its management share options and its convertible debt, the business could have to issue 40 million additional capital shares in the future. Dividing net income by the number of shares outstanding plus the number of shares that could be issued in the future gives the following computation of EPS:

£1.32 billion net income ÷ 440 million capital stock shares = £3.00 EPS

This second computation, based on the higher number of shares, is called the *diluted* earnings per share. (*Diluted* means thinned out or spread over a larger number of shares.) The first computation, based on the number of shares actually outstanding, is called *basic* earnings per share. Publicly owned businesses have to report two EPS figures – unless they have a *simple capital structure* that does not require the business to issue additional shares in the future. Generally, publicly owned companies have *complex capital structures* and have to report two EPS figures. Both are reported at the bottom of the profit and loss account. So the company in this example reports £3.30 basic EPS and £3.00 diluted EPS. Sometimes it's not clear which of the two EPS figures is being used in press releases and in articles giving investment advice. Fortunately, *The Financial Times* and most other major financial publications leave a clear trail of both EPS figures.

Calculating basic and diluted EPS isn't always as simple as our examples may suggest. An accountant would have to adjust the EPS equation for the following complicating things that a business may do:

- Issue additional shares during the year and buy back some of its shares (shares of its stock owned by the business itself that are not formally cancelled are called *treasury stock*).
- Issue more than one class of share, causing net income to be divided into two or more pools – one pool for each class of share.
- Go through a merger (business combination) in which a large number of shares are issued to acquire the other business.

The shareholders should draw comfort from the fact that the top management of many businesses in which they invest are probably just as anxiously reviewing EPS performance as they are. This extract from Tesco's annual accounts reveals much:

Annual bonuses based on achieving stretching EPS growth targets and specific corporate objectives.

- Annual bonuses are paid in shares. On award, the Executive can elect to defer receipt of the shares for a further two years, which is encouraged, with additional matching share awards.
- Longer-term bonus based on a combination of relative total shareholder return, and the achievement of stretching EPS growth targets and specific corporate objectives. Longer-term bonuses are paid in shares, which must be held for a further four years. Executive Directors are encouraged to hold shares for longer than four years with additional matching share awards. Further details are provided below.

- Share options are granted to Executive Directors at market value and can only be exercised if EPS growth exceeds Retail Price Index (RPI) plus 9 per cent over any three years from grant.
- Executive Directors are required to build and hold a shareholding with a value at least equal to their basic salary; full participation in the Executive Incentive scheme is conditional upon meeting this target.

Price/earnings (P/E) ratio

The *price/earnings (P/E) ratio* is another ratio that's of particular interest to investors in public businesses. The P/E ratio gives you an idea of how much you're paying in the current price for the shares for each pound of earnings, or net income, being earned by the business. Remember that earnings prop up the market value of shares, not the book value of the shares that's reported in the balance sheet. (Read on for the book value per share discussion.)

The P/E ratio is, in one sense, a reality check on just how high the current market price is in relation to the underlying profit that the business is earning. Extraordinarily high P/E ratios are justified only when investors think that the company's EPS has a lot of upside potential in the future.

The P/E ratio is calculated as follows:

> Current market price of stock ÷ most recent trailing 12 months diluted EPS = P/E ratio

If the business has a simple capital structure and does not report a diluted EPS, its basic EPS is used for calculating its P/E ratio. (See the earlier section 'Earnings per share, basic and diluted'.)

Assume that the stock shares of a public business with a £3.65 diluted EPS are selling at £54.75 in the stock market. ***Note:*** From here forward, we will use the briefer term EPS in reference to P/E ratios; we assume you understand that it refers to diluted EPS for businesses with complex capital structures and to basic EPS for businesses with simple capital structures.

The actual share price bounces around day to day and is subject to change on short notice. To illustrate the P/E ratio, we use this price, which is the closing price on the latest trading day in the stock market. This market price means that investors trading in the stock think that the shares are worth 15 times diluted EPS (£54.75 market price ÷ £3.65 diluted EPS = 15). This value may be below the broad market average that values shares at, say, 20 times EPS. The outlook for future growth in its EPS is probably not too good.

Dividend yield

The *dividend yield* tells investors how much *cash flow income* they're receiving on their investment. (The dividend is the cash flow income part of investment return; the other part is the gain or loss in the market value of the investment over the year.)

Market cap – not a cap on market value

One investment number you see a lot in the financial press is the *market cap.* No, this does not refer to a cap, or limit, on the market value of a company's capital shares. The term is shorthand for *market capitalisation,* which refers to the total market value of the business that is determined by multiplying the stock's current market price by the total number of shares issued by the company. Suppose a company's stock is selling at £50 per share in the stock market and it has 200 million shares outstanding. Its market cap is £10 billion. Another business may be willing to pay higher than £50 per share for the company. Indeed, many acquisitions and mergers involve the acquiring company paying a hefty premium over the going market price of the shares of the company being acquired.

Suppose that a stock of a public company that is selling for $60 paid $1.20 cash dividends per share over the last year. You calculate dividend yield as follows:

> $1.20 annual cash dividend per share ÷ $60 current market price of stock = 2% dividend yield

You use dividend yield to compare how your stock investment is doing to how it would be doing if you'd put that money in corporate or Treasury bonds, gilt edged stock (UK government borrowings) or other debt securities that pay interest. The average interest rate of high-grade debt securities has recently been three to four times the dividend yields on most public companies; in theory, market price appreciation of the shares over time makes up for that gap. Of course, shareholders take the risk that the market value will not increase enough to make their total return on investment rate higher than a benchmark interest rate. (At the time of writing, this yield gap has shrunk to nothing and is causing an agonizing reappraisal of the value of equities, in relation to debt, as an investment medium.)

Assume that long-term government gilt edged stock are currently paying 6 per cent annual interest, which is 4 per cent higher than the business's 2 per cent dividend yield in the example just discussed. If this business's shares don't increase in value by at least 4 per cent over the year, its investors would have been better off investing in the debt securities instead. (Of course, they wouldn't have had all the perks of a share investment, like those heartfelt letters from the chairman and those glossy financial reports.) The market price of publicly traded debt securities can fall or rise, so things get a little tricky in this sort of investment analysis.

Book value per share

Book value per share is one measure, but it's certainly not the only amount, used for determining the value of a privately owned business's shares. As discussed in Chapter 6, book value is not the same thing as market value. The asset values that a business records in its books (also known as its *accounts*) are *not* the amounts that a business could get if it put its assets up for sale. Book values of some assets are generally lower than what the cost would be for replacing the assets if a disaster (such as a flood or a fire) wiped out the business's stock or equipment. Recording current market values in the books is really not a practical option. Until a seller and a buyer meet and haggle over price, trying to determine the market price for a privately owned business's shares is awfully hard.

You can calculate book value per share for publicly owned businesses too. However, market value is readily available, so shareholders (and investment advisers and managers) do not put much weight on book value per share. EPS is the main factor that affects the market prices of stock shares of public companies – not the book value per share. We should add that some investing strategies, known as *value investing*, search out companies that have a high book value per share compared to their going market prices. But by and large, book value per share plays a secondary role in the market values of stock shares issued by public companies.

Although book value per share is generally not a good indicator of the market value of a private business's shares, you do run into this ratio, at least as a starting point for haggling over a selling price. Here's how to calculate book value per share:

> Total owners' equity ÷ total number of stock shares = book value per share

REAL WORLD EXAMPLE

The business shown in Figure 14-2 has issued 795,000 shares: Its £15.9 million total owners' equity divided by its 795,000 shares gives a book value per share of £20. If the business sold off its assets exactly for their book values and paid all its liabilities, it would end up with £15.9 million left for the shareholders, and it could therefore distribute £20 per share. But the company will not go out of business and liquidate its assets and pay off its liabilities. So book value per share is a theoretical value. It's not totally irrelevant, but it's not all that definitive, either.

Return on equity (ROE) ratio

The *return on equity (ROE) ratio* tells you how much profit a business earned in comparison to the book value of shareholders' equity. This ratio is useful for privately owned businesses, which have no way of determining the current value of owners' equity (at least not until the business is actually sold). ROE is also calculated for public companies, but, just like book value per share, it plays a secondary role and is not the dominant factor driving market prices. (Earnings are.) Here's how you calculate this key ratio:

Net income ÷ owners' equity = ROE

REMEMBER

The owners' equity figure is at book value, which is reported in the company's balance sheet. Chapter 6 explains owners' equity and the difference between share capital and retained earnings, which are the two components of owners' equity.

The business whose profit and loss account and balance sheet are shown in Figures 14-1 and 14-2 earned £1.9 million net income for the year just ended and has £15.9 million owners' equity. Therefore, its ROE is 11.95 per cent (£1.9 million net income ÷ £15.9 million owners' equity = 11.95 per cent). ROE is net income expressed as a percentage of the amount of total owners' equity of the business, which is one of the two sources of capital to the business, the other being borrowed money, or interest-bearing debt. (A business also has non-interest-bearing operating liabilities, such as creditors.) The cost of debt capital (interest) is deducted as an expense to determine net income. So net income 'belongs' to the owners; it increases their equity in the business, so it makes sense to express net income as the percentage of improvement in the owners' equity.

Gearing or leverage

Your company's liquidity keeps you solvent from day to day and month to month and we come to that next when we look at the current ratio and acid test. But what about your ability to pay back long-term debt year after year? Two financial ratios indicate what kind of shape you're in over the long term.

If you've read this chapter from the beginning, you may be getting really bored with financial ratios by now, but your lenders – bankers and bondholders, if you have them – find these long-term ratios to be incredibly fascinating, for obvious reasons.

The first ratio gauges how easy it is for your company to continue making interest payments on the debt:

> Times interest earned = earnings before interest and taxes ÷ interest expense

Don't get confused – earnings before any interest expense and taxes are paid (EBIT) is really just the profit that you have available to make those interest payments in the first place. Figure 14-1, for example, shows an EBIT of \$3,550 (thousand) and an interest expense of \$750 (thousand) this year for a times-interest-earned ratio of 4.73. In other words, this business can meet its interest expense 4.73 times over.

You may also hear the same number called an *interest coverage*. Lenders get mighty nervous if this ratio ever gets anywhere close to 1.0, because at that point, every last penny of profits goes for interest payments on the long-term debt.

The second ratio tries to determine whether the principal amount of your debt is in any danger:

> Debt-to-equity ratio = long-term liabilities ÷ owners' equity

The debt-to-equity ratio says a great deal about the general financial structure of your company. After all, you can raise money to support your company in only two ways: borrow it and promise to pay it back with interest, or sell pieces of the company and promise to share all the rewards of ownership. The first method is debt; the second, equity.

Figure 14-2, for example, shows a debt-to-equity ratio of £6,000 ÷ £15,900, or .38. This ratio means that the company has around three times more equity financing than it does long-term debt.

Lenders love to see lots of equity supporting a company's debt because then they know that the money they loan out is safer. If something goes wrong with the company, they can go after the owners' money. Equity investors, on the other hand, actually want to take on some risk. They like to see relatively high debt-to-equity ratios because that situation increases their leverage and (as the following section points out) can substantially boost their profits. So the debt-to-equity ratio that's just right for your company depends not only on your industry and how stable it is, but also on who you ask.

Current ratio

The *current ratio* is a test of a business's *short-term solvency* – its capability to pay off its liabilities that come due in the near future (up to one year). The ratio is a rough indicator of whether cash-on-hand plus the cash flow from collecting debtors and selling stock will be enough to pay off the liabilities that will come due in the next period.

As you can imagine, lenders are particularly keen on punching in the numbers to calculate the current ratio. Here's how they do it:

Current assets ÷ current liabilities = current ratio

Note: Unlike with most of the other ratios, you don’t multiply the result of this equation by 100 and represent it as a percentage.

Businesses are expected by their creditors to maintain a minimum current ratio (2.0, meaning a 2-to-1 ratio, is the general rule) and may be legally required to stay above a minimum current ratio as stipulated in their contracts with lenders. The business in Figure 14-2 has £17.2 million in current assets and £7,975,000 in current liabilities, so its current ratio is 2.16 and it shouldn’t have to worry about lenders coming by in the middle of the night to break its legs. Chapter 6 discusses current assets and current liabilities and how they are reported in the balance sheet.

How much working capital, ready or nearly ready money do you need to ensure survival? Having the liquid assets available when you absolutely need them to meet short-term obligations is called *liquidity*. You don’t have to have cash in the till to be liquid. Debtors (that is, people who owe you money and can be reasonably expected to cough up soon) and stock ready to be sold are both part of your liquid assets. You can use several financial ratios to test a business’s liquidity, including the current ratio and the acid test. You can monitor these ratios year by year and measure them against your competitors’ ratios and the industry averages.

Acid-test ratio

Most serious investors and lenders don't stop with the current ratio for an indication of the business's short-term solvency – its capability to pay the liabilities that will come due in the short term. Investors also calculate the *acid-test ratio* (also known as the *quick ratio* or the *pounce ratio*), which is a more severe test of a business's solvency than the current ratio. The acid-test ratio excludes stock and prepaid expenses, which the current ratio includes, and limits assets to cash and items that the business can quickly convert to cash. This limited category of assets is known as *quick* or *liquid* assets.

You calculate the acid-test ratio as follows:

Liquid assets ÷ total current liabilities = acid-test ratio

Note: Unlike most other financial ratios, you don't multiply the result of this equation by 100 and represent it as a percentage.

For the business example shown in Figure 14-2, the acid-test ratio is as follows:

Cash	£3,500,000
Marketable securities	none
Debtors	5,000,000
Total liquid assets	£8,500,000
Total current liabilities	£7,975,000
Acid-test ratio	1.07

A 1.07 acid-test ratio means that the business would be able to pay off its short-term liabilities and still have a little bit of liquid assets left over. The general rule is that the acid-test ratio should be at least 1.0, which means that liquid assets equal current liabilities. Of course, falling below 1.0 doesn't mean that the business is on the verge of bankruptcy, but if the ratio falls as low as 0.5, that may be cause for alarm.

This ratio is also known as the *pounce ratio* to emphasise that you're calculating for a worst-case scenario, where a pack of wolves (more politely known as *creditors*) has pounced on the business and is demanding quick payment of the business's liabilities. But don't panic. Short-term creditors do not have the right to demand immediate payment, except under unusual circumstances. This is a very conservative way to look at a business's capability to pay its short-term liabilities – too conservative in most cases.

Keeping track of stock and debtor levels

Two other areas that effect liquidity need to be monitored carefully: how fast your stock is selling out (if your business requires holding goods for sale), and how fast your customers are paying up.

Here's the ratio for stock levels:

> Stock turnover = cost of goods sold ÷ stock

Stock turnover tells you something about how liquid your stocks really are. This ratio divides the cost of goods sold, as shown in your yearly profit and loss account, by the average value of your stock. If you don't know the average, you can estimate it by using the stock figure listed in the balance sheet at the end of the year.

For the business represented in Figures 14-1 and 14-2, the stock turnover is £31,200 ÷ £7,800, or 4.0. This ratio means that this business turns over its stocks four times each year. Expressed in days, the business carries a 91.25-day (365 ÷ 4.0) supply of stock.

REMEMBER

> Is a 90-day plus inventory good or bad? It depends on the industry and even on the time of year. A car dealer who has a 90-day supply of cars at the height of the season may be in a strong stock position, but the same stock position at the end of the season could be a real weakness. As Just In Time (JIT) supply chains and improved information systems make business operations more efficient across all industries, stock turnover is on the rise, and the average number of days that stock of any kind hangs around continues to shrink.

What about debtor levels?

Debtor turnover = sales on credit ÷ debtors

Debtor turnover tells you something about liquidity by dividing the sales that you make on credit by the average debtors. If an average isn't available, you can use the debtors from a balance sheet.

If the business represented in Figures 14-1 and 14-2 makes 80 per cent of its sales on credit, its debtor turnover is (£52,000 × 0.8) ÷ £5,000, or 8.3. In other words, the company turns over its debtors 8.3 times per year, or once every 44 days, on average. That's not too bad: payment terms are 30 days. But remember, unlike fine wine, debtors don't improve with age.

Return on assets (ROA) ratio

As discussed in Chapter 6 (refer to the sidebar 'Trading on the equity: Taking a chance on debt'), one factor affecting the bottom-line profit of a business is whether it used debt to its advantage. For the year, a business may have realised a *financial leverage gain* – it earned more profit on the money it borrowed than the interest paid for the use of that borrowed money. So a good part of its net income for the year may be due to financial leverage. The first step in determining financial leverage gain is to calculate a business's *return on assets (ROA) ratio*, which is the ratio of EBIT (earnings before interest and tax) to the total capital invested in operating assets.

Here's how to calculate ROA:

EBIT ÷ net operating assets = ROA

Note: This equation calls for *net operating assets*, which equals total assets less the non-interest-bearing operating liabilities of the business. Actually, many stock analysts and investors use the total assets figure because deducting all the non-interest-bearing operating liabilities from total assets to determine net operating assets is, quite frankly, a nuisance. But we strongly recommend using net operating assets because that's the total amount of capital raised from debt and equity.

Compare ROA with the interest rate: If a business's ROA is 14 per cent and the interest rate on its debt is 8 per cent, for example, the business's net gain on its debt capital is 6 per cent more than what it's paying in interest. There's a favourable spread of 6 points (one point = 1 per cent), which can be multiplied by the total debt of the business to determine how much its total earnings before income tax is traceable to financial leverage gain.

In Figure 14-2, notice that the company has £10 million total interest-bearing debt (£4 million short-term plus £6 million long-term). Its total owners' equity is £15.9 million. So its net operating assets total is £25.9 million (which excludes the three short-term non-interest-bearing operating liabilities). The company's ROA, therefore, is

£3.55 million earnings before interest and tax ÷ £25.9 million net operating assets = 13.71% ROA

The business earned £1,371,000 (rounded) on its total debt – 13.71 per cent ROA times £10 million total debt. The business paid only £750,000 interest on its debt. So the business had £621,000 financial leverage gain before income tax (£1,371,000 less £750,000). Put another way, the business paid 7.5 per cent interest on its debt but earned 13.71 per cent on this money for a favourable spread of 6.21 points – which, when multiplied by the £10 million debt, yields the £621,000 pre-tax financial gain for the year.

ROA is a useful earnings ratio, aside from determining financial leverage gain (or loss) for the period. ROA is a *capital utilisation* test – how much profit before interest and tax was earned on the total capital employed by the business. The basic idea is that it takes money (assets) to make money (profit); the final test is how much profit was made on the assets. If, for example, a business earns £1 million EBIT on £20 million assets, its ROA is only 5 per cent. Such a low ROA signals that the business is making poor use of its assets and will have to improve its ROA or face serious problems in the future.

Using combined ratios

You wouldn't use a single ratio to decide whether one vehicle was a better or worse buy than another. MPG, MPH, annual depreciation percentage and residual value proportion are just a handful of the ratios that you'd want to review. So it is with a business. You can use a combination of ratios to form an opinion on the financial state of affairs at any one time.

TIP

The best known of these combination ratios is the Altman Z-Score (www.creditguru.com/CalcAltZ.shtml) that uses a combined set of five financial ratios derived from eight variables from a company's financial statements linked to some statistical techniques to predict a company's probability of failure. Entering the figures into the onscreen template at this website produces a score and an explanatory narrative giving a view on the businesses financial strengths and weaknesses.

Appreciating the limits of ratios

A danger with ratios is to believe that because you have a precise number, you have a right figure to aim for. For example, a natural feeling with financial ratios is to think that high figures are good ones, and an upward trend represents the right direction. This theory is, to some extent, encouraged by the personal feeling of wealth that having a lot of cash engenders.

WARNING!

Unfortunately, no general rule exists on which way is right for financial ratios. In some cases a high figure is good; in others, a low figure is best. Indeed, in some circumstances, ratios of the same value aren't as good as each other. Look at the two working capital statements in Table 14-1.

Table 14-1	**Difficult Comparisons**			
	1		***2***	
Current Assets				
Stock	10,000			22,990
Debtors	13,000			100
Cash	100	23,100	10	23,100
Less Current Liabilities				
Overdraft	5,000		90	
Creditors	1,690	6,690	6,690	6,690
Working Capital		16,410		16,410
Current Ratio		3.4:1		3.4:1

The amount of working capital in examples 1 and 2 is the same, \$16,410, as are the current assets and current liabilities, at \$23,100 and \$6,690 respectively. It follows that any ratio using these factors would also be the same. For example, the current ratios in these two examples are both identical, 3.4:1, but in the first case there's a reasonable chance that some cash will come in from debtors, certainly enough to meet the modest creditor position. In the second example there's no possibility of useful amounts of cash coming in from trading, with debtors at only \$100, while creditors at the relatively substantial figure of \$6,600 will pose a real threat to financial stability.

So in this case the current ratios are identical, but the situations being compared are not. In fact, as a general rule, a higher working capital ratio is regarded as a move in the wrong direction. The more money a business has tied up in working capital, the more difficult it is to make a satisfactory return on capital employed, simply because the larger the denominator, the lower the return on capital employed.

In some cases the right direction is more obvious. A high return on capital employed is usually better than a low one, but even this situation can be a danger signal, warning that higher risks are being taken. And not all high profit ratios are good: sometimes a higher profit margin can lead to reduced sales volume and so lead to a lower Return on Capital Employed (ROCE).

In general, business performance as measured by ratios is best thought of as lying within a range; liquidity (current ratio), for example, staying between 1.2:1 and 1.8:1. A change in either direction may represent a cause for concern.

The temptation to compute cash flow per share: Don't give in!

Businesses are prohibited from reporting a *cash flow per share* number on their financial reports. The accounting rule book specifically prohibits very few things, and cash flow per share is on this small list of contraband. Why? Because – and this is somewhat speculative on our part – the powers that be were worried that the cash flow number would usurp net income as the main measure for profit performance. Indeed, many writers in the financial press were talking up the importance of cash flow from profit, so we see the concern on this matter. Knowing how important EPS is for market value of stocks, the authorities declared a similar per share amount for cash flow out of bounds and prohibited it from being included in a financial report. Of course, you could compute it quite easily – the rule doesn't apply to how financial statements are interpreted, only to how they are reported.

Should we dare give you an example of cash flow per share? Here goes: A business with £42 million cash flow from profit and 4.2 million total capital stock shares would end up with £10 cash flow per share. Shhh.

TIP

The Biz/ed (www.bized.co.uk/compfact/ratios/index.htm) and Harvard Business School (http://harvardbusinessonline.hbsp.harvard.edu/b02/en/academic/edu_tk_acct_fin_ratio.jhtml) websites contain free tools that calculate financial ratios from company accounts. They also provide useful introductions to ratio analysis and definitions of each ratio and the formula used to calculate it. To download their spreadsheet, you first need to register with the Harvard website.

TIP

By registering (for free) with the Proshare website (go to www.proshareclubs.co.uk and click on 'Research Centre' and 'Performance Tables'), you have access to a number of tools that crunch public company ratios for you. Select the companies you want to look at, and then the ratios you're most interested in (EPS, P/E, ROI, Dividend

Yield and so on). All is revealed within a couple of seconds. You can then rank the companies by performance in more or less any way you want. You can find more comprehensive tools on the Internet, on the websites of share traders for example, but Proshare is a great site to cut your teeth on – and the price is right!

Frolicking through the Footnotes

Reading the footnotes in annual financial reports is no picnic. The investment pros have to read them because in providing consultation to their clients, they are required to comply with due diligence standards or because of their legal duties and responsibilities of managing other peoples' money.

We suggest you do a quick read-through of the footnotes and identify the ones that seem to have the most significance. Generally, the most important footnotes are those dealing with the following matters:

- **Share options awarded by the business to its executives:** The additional shares issued under share options dilute (thin out) the earnings per share of the business, which in turn puts downside pressure on the market value of its shares, everything else being the same.
- **Pending legal actions, litigation and investigations by government agencies:** These intrusions into the normal affairs of the business can have enormous consequences.
- **Segment information for the business:** Most public businesses have to report information for the major segments of the organisation – sales and operating profit

by territories or product lines. This gives a better glimpse of the different parts making up the whole business. (However, segment information may be reported elsewhere in an annual financial report than in the footnotes.)

These are just three of the many important pieces of information you should look for in footnotes. But you have to stay alert for other critical matters that a business may disclose in its footnotes – scan each and every footnote for potentially important information. Finding a footnote that discusses a major lawsuit against the business, for example, may make the shares too risky for your portfolio.

Checking for Ominous Skies on the Audit Report

The value of analysing a financial report depends directly and entirely on the accuracy of the report's numbers. Top management wants to present the best possible picture of the business in its financial report (which is understandable, of course). The managers have a vested interest in the profit performance and financial condition of the business.

Independent auditors are like umpires in the financial reporting process. The auditor comes in, does an audit of the business's accounting system and procedures, and gives a report that is attached to the company's financial statements. You should check the audit report included with the financial report. Publicly owned businesses are required to have their annual financial reports audited by an independent accountancy firm, and many privately owned businesses have audits done, too, because they know that an audit report adds credibility to the financial report.

What if a private business's financial report doesn't include an audit report? Well, you have to trust that the business prepared accurate financial statements that follow generally accepted accounting principles and that the footnotes to the financial statements provide adequate disclosure.

Unfortunately, the audit report gets short shrift in financial statement analysis, maybe because it's so full of technical terminology and accountant doublespeak. But even though audit reports are a tough read, anyone who reads and analyses financial reports should definitely read the audit report. Chapter 15 provides a lot more information on audits and the auditor's report.

The auditor judges whether the business used accounting methods and procedures in accordance with accepted accounting principles. In most cases, the auditor's report confirms that everything is hunky-dory, and you can rely on the financial report. However, sometimes an auditor waves a yellow flag – and in extreme cases, a red flag. Here are the two most important warnings to watch out for in an audit report:

- The business's capability to continue normal operations is in doubt because of what are known as *financial exigencies*, which may mean a low cash balance, unpaid overdue liabilities or major lawsuits that the business doesn't have the cash to cover.

- One or more of the methods used in the report is not in line with the prevailing accounting body rules, leading the auditor to conclude that the numbers reported are misleading or that disclosure is inadequate.

Although auditor warnings don't necessarily mean that a business is going down the tubes, they should turn on that light bulb in your head and make you more cautious and sceptical about the financial report. The auditor is questioning the very information on which the business's value is based, and you can't take that kind of thing lightly.

In very small businesses it is likely that the accounts will not be independently audited and their accounts come with a rather alarming caveat, running something like this: *These accounts have been prepared on the basis of information provided by the owners and have not been independently verified*. A full audit is an expensive process and few businesses that don't have to will go to the expense and trouble just to be told what they probably already know anyway.

REMEMBER

Just because a business has a clean audit report doesn't mean that the financial report is completely accurate and above board. As discussed in Chapter 15, auditors don't necessarily catch everything. Keep in mind that the accounting rules are pretty flexible, leaving a company's accountants with room for interpretation and creativity that's just short of *cooking the books* (deliberately defrauding and misleading readers of the financial report). Window dressing and profit smoothing – two common examples of massaging the numbers – are explained in Chapter 8.

Finding Financial Facts

Understanding how to calculate financial ratios and how to interpret that data is all fine and dandy, but before you can do anything useful you need to get a copy of the accounts in the first place. Seeing the accounts for your own business shouldn't be too much of a problem. If you're the boss, the accounts should be on your desk right now; if you're not the boss, try snuggling up to the accounts department. If they're too coy to let you have today's figures, the latest audited accounts are in the public domain anyway filed away at Companies House (www.companieshouse.gov.uk), as required by law.

Public company accounts

Most companies make their glossy annual financial reports available to download from their websites, which you can find by typing the company name into an Internet search engine. You need to have Adobe Acrobat Reader on your computer to open the files. No problem, though: Adobe Acrobat Reader is free and you can easily download the program from Adobe's website (http://adobe-reader.download-start.net/download). The software enables you to search for key words in the annual report – a handy feature indeed for tracking down the sections of the report that you're most interested in.

TIP

Yahoo has direct online links to several thousand public company reports and accounts and performance ratios at http://uk.finance.yahoo.com (enter the name of the company you're looking for in the box on the left of the screen under Investing. It appears after you've entered about three letters, click and follow the threads). Paying this site a visit saves you the time and trouble of hunting down company websites.

Private company accounts

Finding financial information on private companies is often a time-consuming and frustrating job. Not for nothing do these companies call themselves 'private'. Businesses, and particularly smaller businesses, can be very secretive about their finances and have plenty of tricks to hide information from prying eyes. Many smaller businesses can elect to file abbreviated accounts with Companies House that provide only the barest details. You can find out just what these shortened accounts must contain at the Business Link website (go to www.businesslink.gov.uk and click on 'Taxes, returns, & payroll', 'Introduction to business taxes' and 'Accounting and audit exceptions for small companies'). The accounts of very small companies don't need to be audited, so the objective reliability of the scant data given may be questionable. Having said that, tens of thousands of private companies file full and generally reliable accounts.

TIP

Two fruitful sources of private company accounts exist:

- **Companies House** (www.companieshouse.gov.uk) is the official repository of all company information in the UK. Their WebCHeck service offers a free Company Names and Address Index that covers 2 million companies, searchable either by company name or by company registration numbers. You can use WebCHeck to purchase (at a cost of £1 per company) a company's latest accounts that give details of sales, profits, margins, directors, shareholders and bank borrowings.

- **Keynote** (www.keynote.co.uk) offers business ratios and trends for 140 industry sectors and provides information to assess accurately the financial health of each industry sector. This service enables you to find out how profitable a business sector is and how successful the main companies operating in each sector are. Executive summaries are free, but expect to pay between £250 and £500 for most reports.

Scoring credit

If all you want is a quick handle on whether a company is likely to be around long enough to pay its bills, including a dividend to shareholders, then a whole heap of information exists about credit status for both individual sole traders and companies of varying complexity. Expect to pay anywhere from £5 for basic information up to £200 for a very comprehensive picture of a company's credit status. So you can avoid trading unknowingly with individuals or businesses that pose a credit risk.

TIP

Experian (www.ukexperian.com), Dun & Bradstreet (www.dnb.com), Creditgate.com (www.creditgate.com) and Credit Reporting (www.creditreporting.co.uk/b2b) are the major agencies compiling and selling credit histories and small-business information. Between them they offer a comprehensive range of credit reports instantly available online that include advice about credit limits.

Using FAME (Financial Analysis Made Easy)

FAME (Financial Analysis Made Easy) is a powerful database that contains information on 7 million companies in the UK and Ireland. Typically, the following information is included: contact information including phone, email and web addresses plus main and other trading addresses; activity details; 29 profit and loss account and 63 balance sheet items; cash flow and ratios; credit score and rating; security and price information (listed companies only); names of bankers, auditors, previous auditors and advisors; details of holdings and subsidiaries (including foreign holdings and subsidiaries); names of current and previous directors with home addresses and shareholder indicator; heads of department; and shareholders. You can compare each company with detailed financials with its peer group based on its activity codes and the software lets you search for companies that comply with your own criteria, combining as many conditions as you like. FAME is available in business libraries and on CD from the publishers, who also offer a free trial (www.bvdinfo.com/Products/Company-Information/National/FAME.aspx).

Looking beyond financial statements

Investors can't rely solely on the financial report when making investment decisions. Analysing a business's financial statements is just one part of the process. You may need to consider these additional factors, depending on the business you're thinking about investing in:

- Industry trends and problems.

- National economic and political developments.
- Possible mergers, friendly acquisitions and hostile takeovers.
- Turnover of key executives.
- International markets and currency exchange ratios.
- Supply shortages.
- Product surpluses.

Whew! This kind of stuff goes way beyond accounting, obviously, and is just as significant as financial statement analysis when you’re picking stocks and managing investment portfolios. A good book for new investors to read is *Investing For Dummies* by Tony Levene.

Chapter 15

Professional Auditors and Advisers

In This Chapter

- Cutting the deck for a fair deal: Why audits are needed
- Interpreting the auditor's report
- Knowing what auditors catch and don't catch
- Growing beyond audits: Professional accountancy practices as advisers and consultants
- Questioning the independence of auditors

If we'd written this chapter 50 years ago, we would have talked almost exclusively about the role of the professional chartered or certified accountant as the *auditor* of the financial statements and footnotes presented in a business's annual financial report to its owners and lenders. Back then, in the 'good old days', audits were a professional accountancy firm's bread-and-butter service – audit fees were a large share of these firms' annual revenue. Audits were the core function that accountants performed then. In addition to audits, accountants provided accounting and tax advice to their clients – and that was pretty much all they did.

Today, accountants do a lot more than auditing. In fact, the profession has shifted away from the expression *auditing* in favour of broader terms like *assurance* and *attestation.* More importantly, accountants have moved into consulting and advising clients on matters other than accounting and tax matters. The movement into the consulting business while continuing to do audits – often for the same clients – has caused all sorts of problems, which this chapter looks at after discussing audits by accountants.

Why Audits?

When I (John) graduated from college, I went to work for a big national accountancy firm. The transition from textbook accounting theory to real-world accounting practice came as a shock. Some of our clients dabbled in window dressing (refer to Chapter 8), and more than a few used earnings management tactics (see profit smoothing in Chapter 8). A few of our clients were engaged in accounting fraud, but just a very few. I was surprised how many businesses cut corners to get things done. Sometimes they were close to acting illegally, and some went over the edge. I soon realised that I had been rather naive, and I came to tolerate most of the questionable practices in the rough and tumble world of business.

I mention my early experience in public accounting to remind you that the world of business is not like Sunday school. Not everything is pure and straight. Nevertheless, legal and ethical lines of conduct separate what is tolerated and what isn't. If you cross the lines, you are subject to legal sanctions and can be held liable to others. For instance, a business can deliberately deceive its investors and lenders with false or misleading numbers in its financial report. Instead of 'What You See Is What You Get' in its financial statements, you get a filtered and twisted version of the business's financial affairs – more of a 'What I Want You to See Is What You Get' version. That's where audits come in.

Audits are the best practical means for keeping fraudulent and misleading financial reporting to a minimum. A business having an independent accounting professional who comes in once a year to check up on its accounting system is like a person getting a physical exam once a year – the audit exam may uncover problems that the business was not aware of, and knowing that the auditors come in once a year to take a close look at things keeps the business on its toes.

The basic purpose of an annual financial statement audit is to make sure that a business has followed the accounting methods and disclosure requirements required by law – in other words, to make sure that the business has stayed in the ballpark of accounting rules. After completing an audit examination, the accountant prepares a short auditor's report stating that the business has prepared its financial statements according to the rules – or has not, as the case may be. In this way, audits are an effective means of enforcing accounting standards.

An audit by an independent accountant provides assurance (but not an iron-clad guarantee) that the business's financial statements follow accepted accounting methods and provide adequate disclosure. This is the main reason why accountancy firms are paid to do annual audits of financial reports. The auditor must be *independent* of the business being audited. The auditor can have no financial stake in the business or any other relationship with the client that may compromise his or her objectivity. However, the independence of auditors has come under scrutiny of late. See the section 'From Audits to Advising' later in the chapter.

The core of a business's financial report is its three primary financial statements – the profit and loss account, the cash flow statement and the balance sheet – and the necessary footnotes to these statements. A financial report may consist of just these statements and footnotes and nothing more. Usually, however, there's more – in some cases, a lot more. Chapter 8 explains the additional content of financial reports of public business corporations, such as the transmittal letter to the owners from the chief executive of the business, historical summaries, supporting schedules and listings of directors and top-level managers – items not often included in the financial reports of private businesses.

The auditor's opinion covers the financial statements and the accompanying footnotes. The auditor, therefore, does not express an opinion of whether the chairman's letter to the shareholders is a good letter – although if the chairman's claims contradicted the financial statements, the auditor would comment on the inconsistency. In short, auditors audit the financial statements and their footnotes but do not ignore the additional information included in annual financial reports.

Although the large majority of audited financial statements are reliable, a few slip through the audit net. Auditor approval is not a 100 per cent guarantee that the financial statements contain no erroneous or fraudulent numbers, or that the statements and their footnotes provide all required disclosures, as the all too frequent Enron-like events attest.

Who's Who in the World of Audits

Chapter 1 explains that to be a qualified accountant, a person usually has to hold a degree, has to pass a rigorous national exam, have audit experience and satisfy continuing education requirements. Many accountants operate as sole practitioners, but many form partnerships (also called firms). An accountancy firm has to be large enough to assign enough staff auditors to the client so that all audit work can be completed in a relatively short period – financial reports are generally released about four to six weeks after the close of the fiscal year. Large businesses need large accountancy firms, and very large global business organisations need very large international accountancy firms. The public accounting profession consists of four very large international firms, several good-sized second-tier national firms, often with international network arrangements, many regional firms, small local firms, and sole practitioners.

All businesses whose ownership units (shares) are traded in public markets in the UK, the US and most other countries with major stock markets are required to have annual audits by independent auditors. Every stock you see listed on the LSE (London Stock Exchange), the NYSE (New York Stock Exchange), NASDAQ (National Association of Securities Dealers Automated Quotations) and other stock-trading markets must be audited by an outside accountancy firm. The Big Four international accountancy firms are household names in the business world. (Big Five until Arthur Andersen sank in the wake of the Enron debacle.)

The Big Four are:

- **Ernst & Young**
- **PricewaterhouseCoopers**
- **Deloitte & Touche**
- **KPMG**

The next ten accountancy firms, in terms of size are:

- Grant Thornton UK
- BDO Stoy Hayward
- RSM Tenon Group
- Baker Tilly
- Smith & Williamson
- PKF (UK)
- Moore Stephens UK
- Mazars
- Vantis
- Begbies Traynor

TIP These guys bob up and down and, on occasion, even dip out of the top spots in this list. Accountancy Age (www.accountancyage.com and select 'Top 50+50' from top menu bar) keeps tabs on their movements each year.

Though these ten are pretty big bears, their combined fee income is less than that of Ernst & Young, the smallest of the Big Four.

The firms are legally organised as limited liability partnerships, so you see *LLP* after their names. The big four international accountancy firms and a handful of those in the second tier audit almost all of the large public corporations in the UK and the US. For these corporations the annual audit is a cost of doing business; it's the price they pay for going into public markets for their capital and for having their shares traded in a public marketplace – which provides liquidity for their shares.

Banks and other lenders to closely held businesses whose ownership shares are not traded in any public marketplace may insist on audited financial statements. We would say that the amount of a bank loan, generally speaking, has to be more than $5 million or $10 million before a lender will insist that the business pay for the cost of an audit. If outside non-manager investors – for example venture capital providers or business angels – have much invested in a business, they will almost certainly insist on an annual audit to be carried out by a substantial firm such as those listed earlier.

Instead of an audit, which they couldn't realistically afford, many smaller businesses have an outside accountant come in regularly to look over their accounting methods and give advice on their financial reporting. Unless an accountant has done an audit, he or she has to be very careful not to express an opinion of the external financial statements. Without a careful examination of the evidence supporting the account balances, the accountant is in no position to give an opinion on the financial statements prepared from the accounts of the business.

In the grand scheme of things, most audits are a necessary evil that does not uncover anything seriously wrong with a business's accounting system and the accounting methods it uses to prepare its financial statements. Overall, the financial statements end up looking virtually the same as they would have looked without an audit. Still, an audit has certain side benefits. In the course of doing an audit, an accountant watches for business practices that could stand some improvement and is alert to potential problems. And fraudsters beware: Accountants may face legal action if they fail to report any dodgy dealings they discover.

The auditor usually recommends ways in which the client's *internal controls* can be strengthened. For example, an auditor may discover that accounting employees are not required to take holidays and let someone else do their jobs while they're gone. The auditor would recommend that the internal control requiring holidays away from the office be strictly enforced. Chapter 2 explains that good internal controls are extremely important in an accounting system. Also, in many audits that we've worked on, we caught several technical errors that were corrected and we suggested minor improvements that were made – the end result being that the financial statements were marginally better than they would have been without the audit.

What an Auditor Does before Giving an Opinion

An auditor does two basic things: *examines evidence* and *gives an opinion* about the financial statements. The lion's share of audit time is spent on examining evidence supporting the transactions and accounts of the business. A very small part of the total audit time is spent on writing the auditor's report, in which the auditor expresses an opinion of the financial statements and footnotes.

This list gives you an idea of what the auditor does 'in the field' – that is, on the premises of the business being audited:

- Evaluates the design and operating dependability of the business's accounting system and procedures.
- Evaluates and tests the business's internal accounting controls that are established to deter and detect errors and fraud.
- Identifies and critically examines the business's accounting methods – especially whether the methods conform to generally accepted accounting rules), which are the touchstones for all businesses.
- Inspects documentary and physical evidence for the business's revenues, expenses, assets, liabilities and owners' equities – for example, the auditor counts products held in stock, observes the condition of those products and confirms checking account balances directly with the banks.

The purpose of all the audit work (examining evidence) is to provide a convincing basis for expressing an opinion of the business's financial statements, attesting that the company's financial statements and footnotes (as well as any directly supporting tables and schedules) can be relied on – or not, in some cases. The auditor puts that opinion in the auditor's report.

The auditor's report is the only visible part of the audit process to financial statement readers – the tip of the iceberg. All the readers see is the auditor's one-page report (which is based on the evidence examined during the audit process, of course). For example, PricewaterhouseCoopers LLP spend thousands of hours auditing Sainsbury's, but the only thing that the shareholders see is the final one-page audit report.

What's in an Auditor's Report

The audit report, which is included in the financial report near the financial statements, serves two useful purposes:

- It reassures investors and creditors that the financial report can be relied upon or calls attention to any serious departures from established financial reporting standards and principles.
- It prevents (in the large majority of cases, anyway) businesses from issuing sloppy or fraudulent financial reports. Knowing that your report will be subject to an independent audit really keeps you on your toes!

JARGON ALERT

The large majority of audit reports on financial statements give the business a clean bill of health, or a *clean opinion.* At the other end of the spectrum, the auditor might state that the financial statements are misleading and should not be relied upon. This negative audit report is called an *adverse opinion.* That's the big stick that auditors carry: They have the power to give a company's financial statements an adverse opinion, and no business wants that. Notice that we say here that the audit firms 'have the power' to give an adverse opinion. In fact, the threat of an adverse opinion almost always motivates a business to give way to the auditor and change its accounting or disclosure in order to avoid getting the kiss of death of an adverse opinion. An adverse audit opinion, if it were actually given, states that the financial statements of the business are misleading, and by implication fraudulent. The LSE and the SEC do not tolerate adverse opinions; they would stop trading in the company's shares if the company received an adverse opinion from its auditor.

Between the two extremes of a clean opinion and an adverse opinion, an auditor's report may point out a flaw in the company's financial statements – but not a fatal flaw that would require an adverse opinion. These are called *qualified opinions*. The following section looks at the most common type of audit report: the clean opinion, in which the auditor certifies that the business's financial statements conform to the rules and are presented fairly.

True and fair, a clean opinion

If the auditor finds no serious problems, the audit firm states that the accounts give a true and fair view of the state of affairs of the company. In the US, the auditor gives the financial report an *unqualified opinion*, which is the correct technical name, but most people call it a *clean opinion*. This expression has started to make its way in UK accounting parlance as the auditing business becomes more international. The clean-opinion audit report runs to about 100 words and three paragraphs, with enough defensive legal language to make even a seasoned accountant blush. This is a clean, or unqualified, opinion in the standard three-paragraph format:

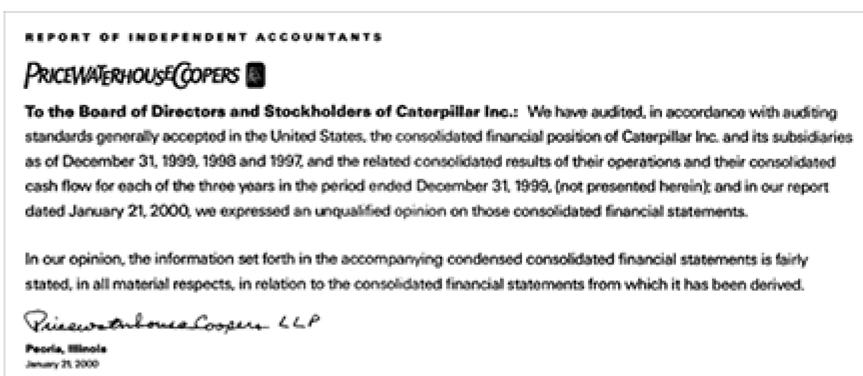
In our opinion:

> *The financial statements give a true and fair view of the state of affairs of the company and the Group at 22 February 2012 and of the profit and cash flows of the Group for the year then ended;*
>
> *The financial statements have been properly prepared in accordance with the Companies Act 1985; and*
>
> *Those parts of the Directors' remuneration report required by Part 3 of Schedule 7A to the Companies Act 1985 have been properly prepared in accordance with the Companies Act 1985.*

1st paragraph	We did the audit, but the financial statements are the responsibility of management; we just express an opinion of them.
2nd paragraph	We carried out audit procedures that provide us a reasonable basis for expressing our opinion, but we don't necessarily catch everything.
3rd paragraph	The company's financial statements conform to GAAP and are not misleading.

Figure 15-1 presents a clean opinion but in a *one*-paragraph format – given by PricewaterhouseCoopers on one of Caterpillar's financial statements. For many years, Price Waterhouse (as it was known before its merger with Coopers) was well known for its maverick one-paragraph audit report.

Figure 15-1: A one-paragraph audit report.



REPORT OF INDEPENDENT ACCOUNTANTS

PRICEWATERHOUSECOOPERS

To the Board of Directors and Stockholders of Caterpillar Inc.: We have audited, in accordance with auditing standards generally accepted in the United States, the consolidated financial position of Caterpillar Inc. and its subsidiaries as of December 31, 1999, 1998 and 1997, and the related consolidated results of their operations and their consolidated cash flow for each of the three years in the period ended December 31, 1999, (not presented herein); and in our report dated January 21, 2000, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

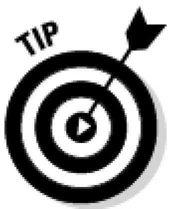
PricewaterhouseCoopers LLP

Peoria, Illinois

January 21, 2000

Other kinds of audit opinions

An audit report that does *not* give a clean opinion may look very similar to a clean-opinion audit report to the untrained eye. Some investors see the name of an audit firm next to the financial statements and assume that everything is okay – after all, if the auditor had seen a problem, the cops would have pounced on the business and put everyone in jail, right? Well, not exactly.



How do you know when an auditor's report may be something other than a straightforward, no-reservations clean opinion? *Look for a fourth paragraph*; that's the key. Many audits require the audit firm to add additional, explanatory language to the standard, unqualified (clean) opinion.

One modification to an auditor's report is very serious – when the audit firm expresses the view that it has substantial doubts about the capability of the business to continue as a going concern. A *going concern* is a business that has sufficient financial wherewithal and momentum to continue its normal operations into the foreseeable future and would be able to absorb a bad turn of events without having to default on its liabilities. A going concern does not face an imminent financial crisis or any pressing financial emergency. A business could be under some financial distress, but overall still be judged a going concern. Unless there is evidence to the contrary, the auditor assumes that the business is a going concern.

But in some cases, the auditor may see unmistakable signs that a business is in deep financial waters and may not be able to convince its creditors and lenders to give it time to work itself out of its present financial difficulties. The creditors and lenders may force the business into involuntary bankruptcy, or the business may make a pre-emptive move and take itself into voluntary bankruptcy. The equity owners (shareholders of a company) may end up holding an empty bag after the bankruptcy proceedings have concluded. (This is one of the risks that shareholders take.) If an auditor has serious concerns about whether the business is a going concern, these doubts are spelled out in the auditor's report.

Auditors also point out any accounting methods that are inconsistent from one year to the next, whether their opinion is based in part on work done by another audit firm, on limitations on the scope of their audit work, on departures from the rules (if they're not serious enough to warrant an adverse opinion) or on one of several other more technical matters. Generally, businesses – and auditors, too – want to end up with a clean bill of health; anything less is bound to catch the attention of the people who read the financial statements. Every business wants to avoid that sort of attention if possible.

Do Audits Always Catch Fraud?

Business managers and investors should understand one thing: Having an audit of a business's financial statements does not guarantee that all fraud, embezzlement, theft and dishonesty will be detected. Audits have to be cost-effective; auditors can't examine every transaction that occurred during the year. Instead, auditors carefully evaluate businesses' internal controls and rely on sampling – they examine only a relatively small portion of transactions closely and in depth. The sample may not include the transactions that would tip off the auditor that something is wrong, however. Perpetrators of fraud and embezzlement are usually clever in concealing their wrongdoing and often prepare fake evidence to cover their tracks.

Looking for errors and fraud

Auditors look in the high-risk areas where fraud and embezzlement are most likely to occur and in areas where the company's internal controls are weak. But again, auditors can't catch everything. High-level management fraud is extraordinarily difficult to detect because auditors rely a great deal on management explanations and assurances about the business. Top-level executives may lie to auditors, deliberately mislead them and conceal things that they don't want auditors to find out about. Auditors have a particularly difficult time detecting management fraud.

Under tougher auditing standards adopted recently, auditors have to develop a detailed and definite plan to search for indicators of fraud, and they have to document the search procedures and findings in their audit working papers. Searching is one thing, but actually finding fraud is quite another. There had been many cases in which high-level management fraud went on for some time before it was discovered, usually not by auditors. The new auditing standard was expected to lead to more effective audit procedures that would reduce undetected fraud.

Unfortunately, it does not appear that things have improved. Articles in the financial press since then have exposed many cases of accounting and management fraud that were not detected or, if known about, were not objected to by the auditors. This is most disturbing. It's difficult to understand how these audit failures and breakdowns happened. The trail of facts is hard to follow in each case, especially by just reading what's reported in the press. Nevertheless, we would say that two basic reasons explain why audits fail to find fraud.

First, business managers are aware that an audit relies on a very limited sampling from the large number of transactions. They know that there is only a needle-in-the-haystack chance of fraudulent transactions being selected for an in-depth examination by the auditor. Second, managers are in a position to cover their tracks – to conceal evidence and to fabricate false evidence. In short, well-designed and well-executed management fraud is extraordinarily difficult to uncover by ordinary audit procedures. Call this *audit evidence failure*; the auditor didn't know about the fraud.

In other situations, the auditor did know what was going on but didn't act on it – call this an *audit judgment failure.* In these cases, the auditor was overly tolerant of wrong accounting methods used by the client. The auditor may have had serious objections to the accounting methods, but the client persuaded the auditor to go along with the methods.

What happens when auditors spot fraud

In the course of doing an audit, the audit firm may make the following discoveries:

- **Errors in recording transactions:** These honest mistakes happen from time to time because of inexperienced bookkeepers, or poorly trained accountants, or simple failure to pay attention to details. No one is stealing money or other assets or defrauding the business. Management wants the errors corrected and wants to prevent them from happening again.
- **Theft, embezzlement and fraud against the business:** This kind of dishonesty takes advantage of weak internal controls or involves the abuse of positions of authority in the organisation that top management did not know about and was not involved in. Management may take action against the guilty parties.
- **Accounting fraud (**also called **financial fraud** or **financial reporting fraud):** This refers to top-level managers who know about and approve the use of misleading and invalid accounting methods for the purpose of disguising the business's financial problems or artificially inflating profit. Often, managers benefit from these improper accounting methods – by propping up the market price of the company's shares to make their stock options more valuable, for example.
- **Management fraud:** In the broadest sense, this includes accounting fraud, but in a more focused sense, it refers to high-level business managers engaging in illegal schemes to line their pockets at the business's expense or knowingly violating laws and regulations that put the business at risk of large criminal or civil penalties. A

manager may conspire with competitors to fix prices or divide the market, for example. Accepting kickbacks or bribes from customers is an example of management fraud – although most management fraud is more sophisticated than taking under-the-table payments.

When the first two types of problems are discovered, the auditor's follow-up is straightforward. Errors are corrected, and the loss from the crime against the business is recorded. (Such a loss may be a problem if it is so large that the auditor thinks it should be disclosed separately in the financial report but the business disagrees and does not want to call attention to the loss.) In contrast, the auditor is between a rock and a hard place when accounting or management fraud is uncovered.

When an auditor discovers accounting or management fraud, the business has to clean up the fraud mess as best it can – which often involves recording a loss. Of course, the business should make changes to prevent the fraud from occurring again. And it may request the resignations of those responsible or even take legal action against those employees. Assuming that the fraud loss is recorded and reported correctly in the financial statements, the auditor then issues a clean opinion on the financial statements. But auditors can withhold a clean opinion and threaten to issue a qualified or adverse opinion if the client does not deal with the matter in a satisfactory manner in its financial statements. That's the auditor's real clout.

The most serious type of accounting fraud occurs when profit is substantially overstated, with the result that the market value of the corporation's shares was based on inflated profit numbers. Another type of accounting fraud occurs when a business is in deep financial trouble but its balance sheet disguises the trouble and makes things look more sound than they really are. The business may be on the verge of financial failure, but the balance sheet gives no clue. When the fraud comes out into the open, the market value takes a plunge, and the investors call their lawyers and sue the business and the auditor.

Investing money in a business or shares issued by a public business involves many risks. The risk of misleading financial statements is just one of many dangers that investors face. A business may have accurate and truthful financial statements but end up in the tank because of bad management, bad products, poor marketing or just bad luck.

All in all, audited financial statements that carry a clean opinion (the best possible auditor's report) are reliable indicators for investors to use – especially because auditors are held accountable for their reports and can be sued for careless audit procedures. (In fact, accountancy firms have had to pay many millions of pounds in malpractice lawsuit damages over the past 30 years, and Arthur Andersen was actually driven out of business.) Auditors usually handle clients for years, if not decades – PricewaterhouseCoopers LLP have been Sainsbury's auditors since 1995 – so if anyone knows where the bodies are it's the auditor. So don't overlook the audit report as a tool for judging the reliability of a business's financial statements. When you read the auditor's report on the annual financial statements from your pension fund manager, hopefully you'll be very reassured! That's your retirement money they're talking about, after all.

Auditors and the Rules

In the course of doing an audit, the accountant often catches certain accounting methods used by the client that violate the prevailing approved and authoritative methods and standards laid down by law that businesses must follow in preparing and reporting financial statements. All businesses are subject to these ground rules. An auditor calls to the attention of the business any departures from the rules, and he or she helps the business make adjustments to put its financial statements back on the right track. Sometimes, a business may not want to make the changes that the auditor suggests because its profit numbers would be deflated. Professional standards demand that the auditor secure a change (assuming that the amount involved is material). If the client refuses to make a change to an acceptable accounting method, the accountant warns the financial report reader in the auditor's report.

Auditors don't allow their good names to be associated with financial reports that they know are misleading if they can possibly help it. Every now and then, we read in the financial press about an audit firm walking away from a client ('withdraws from the engagement' is the official terminology). As mentioned earlier in this chapter, everything the auditor learns in the course of an audit is confidential and cannot be divulged beyond top management and the board of directors of the business. A

> *confidential relationship* exists between the auditor and the client – although it is not equal to the privileged communication between lawyers and their clients.

If an auditor discovers a problem, he or she has the responsibility to move up the chain of command in the business organisation to make sure that one level higher than the source of the problem is informed of the problem. But the board of directors is the end of the line. The auditor does not inform the LSE, the SEC or another regulatory agency of any confidential information learned during the audit.

However, most outside observers will work on the ‘no smoke without fire’ principle. No firm, yet alone an accountancy partnership with their partnership profit share on the line, willingly gives up a lucrative client.

Auditors, on the other hand, are frequently being replaced, often for cost reasons – auditing is a negotiable deal too – but also because the firm being audited may have simply outgrown the auditor. This happens fairly frequently when a business is going for a public listing of its shares. The guy round the corner, who was cheap and competent, cuts no ice with the big wheels at the LSE and the placing houses that have to sell the shares. They want a big name auditor to help the PR push.

We can’t exaggerate the importance of reliable financial statements that are prepared according to uniform standards and methods for measuring profit and putting values on assets, liabilities and owners’ equity. Not to put too fine a point on it, the flow of capital into businesses and the market prices of shares traded in the public markets (the London Stock Exchange, the New York Stock Exchange and over the NASDAQ network) depend on the information reported in financial statements.

The US Sarbanes-Oxley Act (known less commonly but better understood as the Public Company Accounting Reforms and Investor Protection Act – 2002) and the UK 'Companies (Audit, Investigations and Community Enterprise) Act – 2004' were brought in to ensure truthfulness in financial accounting (refer to Chapter 1 for more details about Sarbanes-Oxley). Despite the pain involved for businesses, the end result of complying with the acts will hopefully be a set of audited accounts that outsiders place more reliance on than ever before.

Also, smaller, privately owned businesses would have a difficult time raising capital from owners and borrowing money from banks if no one could trust their financial statements. Generally accepted accounting principles, in short, are the gold standard for financial reporting. Once financial reporting standards have been put into place, how are the standards enforced? To a large extent, the role of auditors is to do just that – to enforce the rules. The main purpose of having annual audits, in other words, is to keep businesses on the straight-and-narrow path and to prevent businesses from issuing misleading financial statements. Auditors are the guardians of the financial reporting rules. We think most business managers and investors agree that financial reporting would be in a sorry state of affairs if auditors weren't around.

From Audits to Advising

If Accountant Rip van Winkle woke up today after his 20-year sleep, he would be shocked to find that accountancy firms make most of their money not from doing audits but from advising clients. A recent advertisement by one of the Big Four international accountancy firms listed the following services: 'assurance, business consulting, corporate finance, eBusiness, human capital, legal services, outsourcing, risk consulting, and tax services'. (Now, if the firm could only help you with your back problems!) Do you see audits in this list? No? Well, it's under the first category – assurance. Why have accountancy firms moved so far beyond audits into many different fields of consulting?

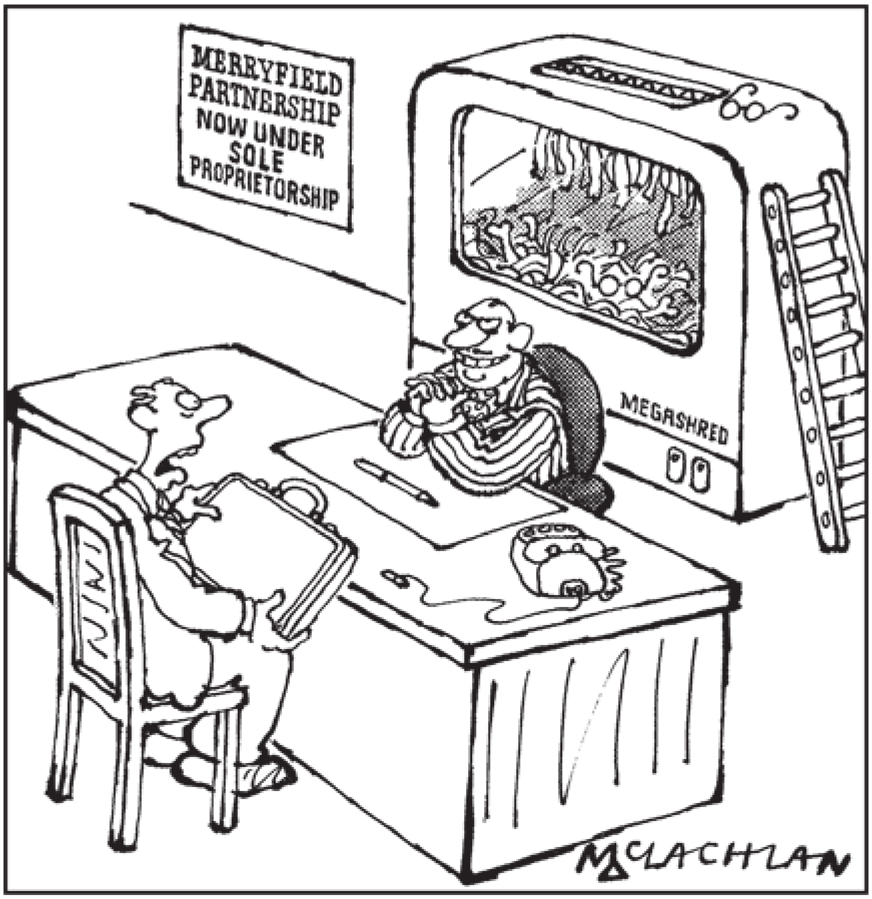
We suspect that many businesses do not view audits as adding much value to their financial reports. True, having a clean opinion by an auditor on financial statements adds credibility to a financial report. At the same time, managers tend to view the audit as an intrusion, and an override on their prerogatives regarding how to account for profit and how to present the financial report of the business. Most audits, to be frank about it, involve a certain amount of tension between managers and the audit firm. After all, the essence of an audit is to second-guess the business's accounting methods and financial reporting decisions. So it's quite understandable that accountancy firms have looked to other types of services they can provide to clients that are more value-added and less adversarial – and that are more lucrative.

Nevertheless, many people have argued that accountancy firms should get out of the consulting and advising business – at least to the same clients they audit. For the first years of this millennium, things seemed to be moving in this direction, and new legislation gave them a none-too-gentle prod. Arthur Andersen only just split their consultancy business off before they went under themselves. Luckily, they changed the name of the consulting business from Andersen to Accenture, ditching a fair amount of the bad odour that attached itself to the accountancy practice's name. Now the pendulum is swinging back and big accountancy firms are pushing an integrated approach, arguing that clients don't want to have to explain largely the same business facts to different teams of 'visiting firemen'. Although the Big Four are back in the consulting game, figures from the Management Consultancies Association suggest that accountancy firms only have 16 per cent of the market for consultancy services, right now at least.

Sometimes we take the pessimistic view that in the long run accountants will abandon audits and do only taxes and consulting. Who will do audits then? Well, a team of governmental auditors could take over the task – but we don’t think this would be too popular.

Part V

The Part of Tens



'Before we get down to business, I couldn't help noticing what an unusually large shredder you have.'

In this part . . .

The Part of Tens contains four shorter chapters. The first chapter presents ten tools and techniques that are useful in running a business and getting the most from your accounting system. These top ten topics are summarised and condensed, and constitute a compact accounting tool kit for managers. The second chapter looks at the range of options available to finance a business and covers the field from international stock markets to government grants. The third chapter provides investors with a checklist of the top ten things they should look for when reading a financial report in order to gain the maximum amount of information in the minimum amount of time. The final chapter provides insights on getting to grips with the future; a veritable financial crystal ball.

Chapter 16

Ten Ways Savvy Business Managers Use Accounting

In This Chapter

- Making better profit decisions
- Leveraging – both the operating kind and the financial kind
- Putting your finger on the pulse of cash flow
- Better budgeting for planning and control
- Developing financial controls
- Taking charge of the accounting function
- Explaining your financial statements to others

So how can accounting help make you a better business manager? This is the bottom-line question. Speaking of the bottom line, that's exactly the place to start. Accounting provides the financial information and analysis tools you need for making insightful profit decisions – and stops you from plunging ahead with gut decisions that may feel right but that don't hold water after diligent analysis.

Make Better Profit Decisions

Making profit starts with earning margin on each unit sold and then selling enough units to overcome your total fixed expenses for the period (the basic concept that we explain more fully in

Chapter 9). We condense the accounting model of profit into the following equation:

(Margin per unit × sales volume) – fixed expenses = profit

Note: Profit here is *before* corporation tax. Regular corporations pay tax based on the amount of their taxable income; different rates apply to different brackets of taxable income. The bottom-line net income in the profit and loss account of a business is after-tax income. A business may distribute all, part or none of its profit for the year to its owners.

Insist that your accountant determines the margin per unit for all products you sell. The margin is also called the *contribution margin* to emphasise that it contributes toward the business's fixed expenses. Here's an example for determining the *margin per unit* for a product:

Margin Factors	Amount
Sales price	£100.00
Less product cost	60.00
Equals gross margin	£40.00
Less sales revenue-driven expenses	8.00
Less sales volume-driven expenses	5.00
Equals margin per unit	£27.00

We'd bet that your accountant provides the gross margin (also called *gross profit*) on your products. So far, so good. But don't stop at the gross margin line. Push your accountant to determine the two variable expenses for each product. In this example, you don't make $40 per unit sold; you make only $27 from selling the product. Two products may have the same $40 gross profit, but one could provide a $27 margin and the other a $32 margin because the second one's variable expenses are lower.

Have your accountant differentiate between *revenue*-driven and *volume*-driven variable expenses for each product. Suppose you raise the sales price to $110.00, a 10 per cent increase. The sales revenue-driven expense increases by 10 per cent as well, to $8.80, because these expenses (such as sales commission) are a certain *percentage* of the sales price. Your margin increases not $10.00, but only $9.20 (the $10.00 sales price increase minus the $0.80 expense increase). In contrast, the higher sales price by itself does not increase the sales volume-driven expenses (such as shipping costs); these expenses remain at $5.00 per unit unless other factors cause them to increase.

You earn profit (or to be precise, profit before tax) by selling enough products that your total margin is higher than your total fixed expenses for the period. The excess of total margin over fixed expenses is profit before tax. Setting sales prices to generate an adequate total contribution margin is one of the most important functions of managers.

When thinking about changing sales price, focus on what happens to the *margin per unit*. Suppose, for example, that you're considering dropping the sales price 10 per cent from £100.00 to £90.00. You predict that your product cost and variable expenses will remain unchanged. Here's what would happen to your margin:

Margin Factors	After	Before
Sales price	£90.00	£100.00
Less product cost	60.00	60.00
Equals gross margin	£30.00	£40.00
Less sales revenue-driven expenses	7.20	8.00
Less sales volume-driven expenses	5.00	5.00
Equals margin per unit	£17.80	£27.00

Your margin would plunge £9.20 per unit – more than one-third!

Suppose you sold 100,000 units of this product during the year just ended. These sales generated £2.7 million total margin. If you drop the sales price, you give up £920,000 total margin. Where will the replacement come from for this £920,000 contribution margin? Higher sales volume? Sales volume would have to increase more than 50 per cent to offset the drastic drop in the contribution margin per unit. You'd better have a good answer. The profit model directs attention to this critical question and gives you the amount of margin sacrificed by dropping the sales price.

Understand That a Small Sales Volume Change Has a Big Effect on Profit

Is that big push before year-end for just 5 per cent more sales volume really that important? You understand that more sales mean more profit, of course. But what's the big deal? A 5 per cent increase in sales volume means just 5 per cent more profit, doesn't it? Oh no. If you think so, you need to read Chapter 9. Because fixed expenses are just that – fixed and unchanging over the short run. Seemingly small changes in sales volume cause large swings in profit. This effect is called *operating leverage*.

The following example illustrates operating leverage. Suppose your £12.5 million annual fixed expenses provide the personnel and physical resources to sell 625,000 units over the year. However, you didn't hit capacity; your company's actual sales volume was 500,000 units for the year, or 80 per cent of sales capacity – which isn't bad. Your average margin across all products is £30 per unit. Using the basic profit equation, you determine profit before income tax as follows:

[£30 margin per unit × 500,000 units] =	£15,000,000	contribution margin
	– 12,500,000	fixed expenses
	= £2,500,000	pre-tax profit

Now, what if you had sold 25,000 more units, which is just 5 per cent more sales volume? Your fixed expenses would have been the same because sales volume would still be well below the sales capacity provided by your fixed expenses. Therefore, the profit increase would have been the £30 margin per unit times the 25,000 additional units sold, or £750,000. This is a 5 per cent gain in contribution margin. But compared to the £2,500,000 pre-tax profit, the additional £750,000 is a 30 per cent gain – from only a 5 per cent sales volume gain, which is a 6-to-1 payoff!

JARGON ALERT

Operating leverage refers to the wider swing in profit rather than the smaller swing in sales volume. In this example, a 5 per cent increase in sales volume would cause a 30 per cent increase in profit. Unfortunately, operating leverage cuts both ways. If your sales volume had been 5 per cent less, your profit would have been £750,000 less, which would have resulted in 30 per cent less profit.

Here's a quick explanation of operating leverage. In this example, total contribution margin is 6 times profit: £15 million contribution margin ÷ £2.5 million profit = 6. So a 5 per cent swing in contribution margin has a 6-times effect, or a 30 per cent impact on profit. Suppose a business had no fixed expenses (highly unlikely). In this odd situation, there is no operating leverage. The percentage gain or loss in profit would equal the percentage gain or loss in sales volume.

The fundamental lesson of operating leverage is to make the best use you can of your fixed expenses – that is, take advantage of the capacity provided by the resources purchased with your fixed expenses. If your sales volume is less than your sales capacity, the unsold quantity would have provided a lot more profit. Most businesses are satisfied if their actual sales volume is 80–90 per cent of their sales capacity. But keep in mind one thing: That last 10 or 20 per cent of sales volume would make a dramatic difference in profit!

Fathom Profit and Cash Flow from Profit

Profit equals sales revenue minus expenses – you don't need to know much about accounting to understand this definition. However, business managers should dig a little deeper. First, you should be aware of the accounting problems in measuring sales revenue and expenses. Because of these problems, profit is not a clear-cut and precise number. Second, you should know the real stuff of profit and know where to find profit in your financial statements.

Profit is not a politically correct term. Instead, business financial reports call profit *net income* or *net earnings*. So don't look for the term *profit* in external financial statements. Remember, net income (or net earnings) = bottom-line profit after tax.

Profit accounting methods are like hemlines

Profit is not a hard-and-fast number but is rather soft and flexible on the edges. For example, profit depends on which accounting method is selected to measure the cost-of-goods-sold expense, which is usually the largest expense for businesses that sell products. The rules of the game, called *generally accepted accounting principles* (or GAAP for short), permit two or three alternative methods for measuring cost of goods sold and for other expenses as well. (Chapter 13 discusses accounting methods.)

When evaluating the profit performance of your own business or when sizing up the net income record of a business you're considering buying, look carefully at whether profit measurement is based on stingy (conservative) or generous (liberal) accounting methods. You can assume that profit is in the GAAP ballpark, but you have to determine whether profit is in the right field or the left field (or perhaps in centre field). Businesses are not required to disclose how different the profit number would have been for the period if different accounting methods had been used, but they do have to reveal their major accounting methods in the footnotes to their annual financial statements.

The real stuff of profit

Most people know that, in the general sense of the word, *profit* is a gain, or an increase in wealth, or how much better off you are. But managers and investors hit the wall when asked to identify the real stuff of profit earned by a business. To make our point, suppose that your business's latest annual profit and loss account reports £10 million sales revenue and £9.4 million expenses, which yields £600,000 bottom-line net income. Your profit ratio is 6 per cent of sales revenue, which is about typical for many businesses. But we digress.

Our question is this: *Where is that £600,000 of profit?* Can you find and locate the profit earned by your business? Is it in cash? If not, where is it? If you can't answer this question, aren't you a little embarrassed? Quick – go and read Chapter 5!

Profit accounting is more complicated than simple cash-in, cash-out bookkeeping. Sales for cash increase cash, of course, but sales on credit initially increase an asset called debtors. So *two* assets are used in recording sales revenue. Usually, a minimum of four assets and two liabilities are used in recording a business's expenses. To locate profit, you have to look at all the assets and liabilities that are changed by revenue and expenses. The *measure* of profit is found in the profit and loss account. But the *substance* of profit is found in assets and liabilities, which are reported in the *balance sheet*.

Your accountant will have determined that your £600,000 net income consists of the following three components:

£600,000 profit = £420,000 cash + £290,000 net increase in other assets – £110,000 increase in liabilities

This is a typical scenario for the makeup of profit – we don't mean the pound amounts but rather the three components of profit. The pound amounts of the increases or decreases in assets and liabilities vary from business to business, of course, and from year to year. But rarely would the profit equation be

£600,000 profit = £600,000 cash

Cash is only one piece of the profit pie. Business managers need accounting to sort out how profit is divided among the three components – in particular, you need to know the cash flow generated from profit.

Govern Cash Flow Better

A business wants to make profit, of course, but equally important, a business must convert its profit into *usable cash flow*. Profit that is never turned into cash or is not turned into cash for a long time is not very helpful. A business needs cash flow from profit to provide money for three critical uses:

- To distribute some of its profit to its equity (owner) sources of capital – to provide a cash income to them as compensation for their capital investment in the business.
- To grow the business – to invest in new fixed (long-term) operating assets and to increase its stock and other short-term operating assets.
- To meet its debt payment obligations and to maintain the general liquidity and solvency of the business.

One expense, depreciation, is not a cash outlay in the period it's recorded as an expense. Rather, depreciation expense for a period is an allocated amount of the original cost of the business's fixed assets that were bought and paid for in previous years. More importantly, the sales revenue collected by the business includes money for its depreciation expense. Thus the business converts back into cash some of the money that it put in its fixed assets years ago. Understanding how depreciation works in cash flow analysis is very important.

In one sense, you can say that depreciation generates cash flow. But please be careful here. This does *not* mean that if you had recorded more depreciation expense, you would have had more cash flow. What it means is that through making sales at prices that include recovery of some of the cost of fixed assets, your sales revenue (to the extent that it is collected by year-end) includes cash flow to offset the depreciation expense.

To illustrate this critical point, suppose a business did not make a profit for the year but did manage to break even. In this zero-profit situation, there is cash flow from profit because of depreciation. The company would realise cash flow equal to its depreciation for the year – assuming that it collected its sales revenue. Depreciation is a process of recycling fixed assets back into cash during the year, whether or not the business makes a profit.

In the example in the preceding section, the business earned £600,000 net income (profit). But its cash increased only £420,000. Why? The *cash flow statement* provides the details. In addition to reporting the depreciation for the year, the first section of the cash flow statement reports the short-term operating asset and liability changes caused by the business's sales and expenses. These changes either help or hurt cash flow from profit (from operating activities, to use the correct technical accounting term).

An increase in debtors hurts cash flow from profit because the business did not collect all its sales on credit for the year. An increase in stock hurts cash flow from profit because the business replaces the products sold and spends more money to increase its stock of products. On the other hand, an increase in creditors or accrued expenses payable helps cash flow from profit. These two liabilities are, basically, unpaid expenses. When these liabilities increase, the business did not pay all its expenses for the year – and its cash outflows for expenses were less than its expenses.

> Generally speaking, growth hurts cash flow from profit. To grow its sales and profit, a business usually has to increase its debtors and stock. Some of this total increase is offset by increases in the business's short-term operating liabilities. Usually, the increase in assets is more than the increase in liabilities, particularly when growth is faster than usual, and therefore cash flow from profit suffers. When a business suffers a decline in sales revenue, its bottom-line profit usually goes down – but its cash flow from profit may not drop as much as net profit, or perhaps not at all. A business should decrease its debtors and stock at the lower sales level; these decreases help cash flow from profit. Even if a business reported a loss for the year, its cash flow from profit could be positive because of the depreciation factor and because the business may have reduced its debtors and stock.

Call the Shots on Your Management Accounting Methods

Business managers too often defer to their accountants in choosing accounting methods for measuring sales revenue and expenses. You should get involved in making these decisions. The best accounting method is the one that best fits the operating methods and strategies of your business. As a business manager, you know these operating methods and strategies better than your accountant. Chapter 13 gives you the details on various accounting methods.

For example, consider sales prices. How do you set your sales prices? Many factors affect your sales prices, of course. What we're asking here concerns your general sales pricing policy relative to product cost changes. For example, if your product cost goes up, do you allow your 'old' stock of these products to sell out before you raise the sales price? In other words, do you generally wait until you start selling the more recently acquired, higher-cost products before you raise your sales price? If so, you're using the first-in, first-out (FIFO) method. You might prefer to keep your cost-of-goods-sold expense method consistent with your sales pricing method. But the accountant may choose the last-in, first-out (LIFO) expense method, which would mismatch the higher-cost products with the lower-sales-price products.

The point is this: Business managers formulate a basic strategy regarding expense recovery. Sales revenue has to recoup your expenses to make a profit. How do you pass along your expenses to your customers in the sales prices you charge them? Do you attempt to recover the cost of your fixed assets as quickly as possible and set your sales prices on this basis? Then you should use a fast, or *accelerated*, depreciation method. On the other hand, if you take longer to recover the cost of your fixed assets through sales revenue, then you should probably use the longer-life *straight-line* depreciation method.

In short, we encourage you to take charge and choose the accounting methods that best fit your strategic profit plan. You need to speak some of the accounting language and know which accounting methods are available. In short, business managers should take charge of the accounting function just like they take charge of marketing and other key functions of the business.

This applies only to management accounting. Your accountants and auditors will call the shots when preparing accounts for the outside world.

Build Better Budgets

Budgeting (explained in Chapter 10) provides important advantages – first, for understanding the profit dynamics and financial structure of your business, and second, for planning for changes in the coming period. Budgeting forces you to focus on the factors that have to improve in order to increase profit and helps you prepare for the future. The basic profit model provides the framework for the profit budget. A good profit model is the essential starting point for budgeting. To develop your profit plan for the coming year, focus on the following:

- Margins
- Sales volume
- Fixed expenses

The profit budget, in turn, lays the foundation for changes in your operating assets and liabilities that are driven by sales revenue and expenses. Suppose you project a 10 per cent rise in sales revenue. How much will your debtors asset increase? Suppose your sales volume target for next year is 15 per cent higher than this year. How much will your stock increase? The budgeted changes in sales revenue and expenses for next year lead directly to the budgeted changes in operating assets and operating liabilities. These changes, in turn, direct attention to two other key issues.

First, if things go according to plan, how much cash flow from profit will be generated? Second, will you need more capital, and where will you get this money? You need the budgeted cash flow from profit (operating activities) for the coming year for three basic financial planning decisions:

- **Cash distributions from profit to owners** (cash dividends to shareholders of companies and cash distributions to partners).
- **Capital expenditures** (purchases of new fixed assets to replace and upgrade old fixed assets and to expand the business's capacity).
- **Raising capital** from borrowing on debt and, possibly, raising new equity capital from owners.

The higher your budgeted cash flow from profit, the more flexibility you have in having money available for cash distributions from profit and for capital expenditures and the less pressure to go out and raise new capital from debt and equity sources of capital.

To sum up, your profit budget is dovetailed with the assets and liabilities budget and the cash flow budget. Your accountant takes your profit budget (your strategic plan for improving profit) and builds the budgeted balance sheet and the budgeted cash flow statement. This information is essential for good planning – focusing in particular on how much cash flow from profit will be realised and how much capital expenditures will be required, which in turn lead to how much additional capital you have to raise and how much cash distribution from profit you will be able to make.

Optimise Capital Structure and Financial Leverage

Our friend Ron, a florist, made this point one night: ‘To make profit, you must make sales.’ We quickly added that you also must invest in operating assets, which means that you must raise capital. Where do you get this money? Debt and equity are the two basic sources. *Equity* refers to the money that owners invest in a business with the hopes that the business will turn a profit. Profit builds the value of owners’ equity; profit fundamentally is an increase in assets that accrues to the benefit of the owners. Chapter 11 discusses ownership structures; Chapter 6 covers debt and equity.

The return on the owners' equity interest in the business consists of two quite distinct parts:

- Cash distributions from profit to the owners.
- Increases in the value of their ownership interest in the business.

In contrast, lenders are paid a *fixed* rate of interest on the amount borrowed. This fixed nature of interest expense causes a *financial leverage* or *gearing* effect that either benefits or hurts the amount of profit remaining for the equity investors in the business.

Financial leverage refers in general to using debt in addition to equity capital. A financial leverage gain (or loss) refers to the difference between the earnings before interest and tax (EBIT) that a business can make on its debt capital versus the interest paid on the debt. The following example illustrates a case of financial leverage gain.

REAL WORLD EXAMPLE

Your business earned £2.1 million EBIT for the year just ended. Your net operating assets are £12 million – recall that net operating assets equal total assets less non-interest-bearing operating liabilities (mainly creditors and accrued expenses payable). Thus your total capital sources equal £12 million. Suppose you have £4 million debt. The other £8 million is owners' equity. You paid 8 per cent annual interest on your debt, or £320,000 total interest. Debt furnishes one-third of your capital, so one-third of

EBIT is attributed to this capital source. One-third of EBIT is £700,000. But you paid only £320,000 interest for this capital. You earned £380,000 more than the interest. This is the amount of your pre-tax *financial leverage gain*.

Three factors determine financial leverage gain (or loss):

- Proportion of total capital provided from debt.
- Interest rate.
- Return on assets (ROA), or the rate of EBIT the business can earn on its total capital invested in its net operating assets.

In the example, your business earned 17.5 per cent on its net operating assets (£2.1 million EBIT ÷ £12 million total net operating assets). You used £4 million debt capital for the investment in your net operating assets, and you paid 8 per cent annual interest on the debt, which gives a favourable 9.5 per cent spread (17.5 per cent – 8 per cent). The 9.5 per cent favourable spread times £4 million debt equals the £380,000 leverage gain for the year (before tax).

Business managers should watch how much financial leverage gain contributes to the earnings for owners each year. In this example, the after-interest earnings for owners is £1,780,000 (equal to EBIT less interest expense). The £380,000 financial leverage gain provided a good part of this amount. Next year, one or more of the three factors driving the financial leverage gain may change. Savvy business managers sort out each year how much financial leverage impacts the earnings available for owners. Check out Chapter 14 for more on leverage, or *gearing* as it is also known.

A financial leverage gain enhances the earnings on owners' equity capital. The conventional wisdom is that a business should take advantage of debt that charges a lower interest rate than it can earn on the debt capital. Looking at the bigger picture, however, the long-run success of a business depends mainly on maintaining and improving the factors that determine its profit from operations (EBIT) – rather than going overboard and depending too much on financial leverage.

Develop Better Financial Controls

Experienced business managers can tell you that they spend a good deal of time dealing with problems. Things don't always go according to plan. Murphy's Law (if something can go wrong, it will, and usually at the worst possible time) is all too true. To solve a problem, you first have to know that you have one. You can't solve a problem if you don't know about it. Managers are problem solvers; they need to get on top of problems as soon as possible. In short, business managers need to develop good *financial controls*.

Financial controls act like trip wires that sound alarms and wave red flags for a manager's attention. Many financial controls are accounting-based. For example, actual costs are compared with budgeted costs or against last period's costs; serious variances are highlighted for immediate management attention. Actual sales revenue for product lines and territories are compared with budgeted goals or last period's numbers. Cash flow from profit period by period is compared with the budgeted amount of cash flow for the period from this source. These many different financial controls don't just happen. You should identify the handful of critical factors that you need to keep a close eye on and insist that your internal accounting reports highlight these operating ratios and numbers.

You must closely watch the margins on your products. Any deviation from the norm – even a relatively small deviation – needs your attention immediately. Remember that the margin per unit is multiplied by sales volume. If you sell 100,000 units of a product, a slippage of just 50 pence causes your total margin to fall £50,000. Of course, sales volume must be closely watched, too; that goes without saying. Fixed expenses should be watched in the early months of the year to see whether these costs are developing according to plan – and through the entire year.

Debtors' collections should be monitored closely. Average days before collection is a good control ratio to keep your eye on, and you should definitely get a listing of past-due customers' accounts. Stock is always a problem area. Watch closely the average days in stock before products are sold, and get a listing of slow-moving products. Experience is the best teacher. Over time you learn which financial controls are the most important to highlight in your internal accounting reports. The trick is to make sure that your accountants provide this information.

Minimise Tax

The first decision regarding tax concerns which type of legal ownership structure to use for carrying on the activities of the business, which is discussed in Chapter 11. When two or more owners provide capital for the business, you have two basic choices:

- A *partnership* – a specific contractual agreement among the owners regarding division of management authority, responsibilities and profit.
- A *limited liability company*, which has many characteristics of a partnership but is a separate legal entity, like a corporation.

Partnerships are *pass-through* tax entities. A pass-through business entity pays no tax on its taxable income but passes the obligation to its owners, who pick up their shares of the total taxable income in their individual income tax returns. In contrast, the individual shareholders of companies pay tax only on the amount of actual cash dividends from profit distributed by the company. Keep in mind here that the company pays corporation tax based on its taxable income. Factors other than tax affect the choice of ownership structure. You need the advice of tax professionals and financial consultants.

Regardless of the ownership structure, you should understand how accounting methods determine taxable income. Basically, the choice of accounting methods enables you to shift the timing of expenses – such as depreciation and cost of goods sold – between early years and later years. Do you want more expense deductions this year? Then choose the last-in, first-out (LIFO) method for cost-of-goods-sold expense and an accelerated method for depreciation. But keep in mind that what you gain today, you lose tomorrow. Higher expense deductions in early years cause lower deductions in later years. Also, these income-tax-driven accounting choices make the stock and fixed assets in your balance sheet look anaemic. Remember that expenses are asset decreases. You want more expense? Then lower asset values as reported in your balance sheet.

Think twice before jumping on the tax minimisation bandwagon. Knowing about accounting methods and their effects in both the profit and loss account and the balance sheet helps you make these important decisions.

Explain Your Financial Statements to Others

On many occasions, as a business manager you have to explain your financial statements to others:

- When applying for a loan.
- When talking with people or other businesses who may be interested in buying your business.
- When dealing with the press.
- When dealing with unions or other employee groups in setting new wages and benefit packages.
- When explaining the profit-sharing plan to your employees.
- When reporting financial statement data to national trade associations that collect this information from their members.
- When presenting the annual financial report before the annual meeting of owners.

Knowledge of financial statement reporting and accounting methods is also extremely useful when you sit on a bank's board of directors, or a hospital board, or any of several other types of oversight boards. In the preceding list, you're the explainer, the one who has to do the explaining. As a board member, you're the explainee, the person who has to make sense of the financial statements and accounting methods being presented. A good accounting foundation is invaluable.

Part II of this book shows you how to understand financial reports. In brief, you need a good grip on the purpose, nature and limitations of each of the three primary financial statements reported by a business:

- **The profit and loss account:** Many people think that bottom-line profit is cash in the bank, but you know better.
- **The cash flow statement:** Many people just add back depreciation to net income to determine cash flow from profit, but you know better.
- **The balance sheet:** Many people think that this financial statement reports the current values for assets, but you know better.

We'll tell you one disadvantage of knowing some accounting: The other members of the board will be very impressed with your accounting knowledge and may want to elect you chairperson.

A short word on massaging the numbers: Don't!

I (John) taught accounting to future business managers and accountants. I didn't encourage profit smoothing, window dressing and other techniques for manipulating accounting numbers to make a company's financial statements look better – no more than my marketing professor colleagues encouraged their students to engage in deceptive advertising tactics. Yet these things go on, and I felt obligated to expose my students to these practices as a warning that accountants face difficult moral decisions. In a similar vein, I caution you, a business manager, that you will surely face pressures from time to time to massage the accounting numbers – to make profit look smoother from year to year, or to make the short-term solvency of the business look better (by window dressing). Don’t!

Chapter 17

Ten Places a Business Gets Money From

In This Chapter

- Checking out stock markets
- Getting private investors on board
- Banking on the banks
- Financing short- and long-term assets
- Looking for government loot
- Winning free dosh
- Redeploying pensions

All business ventures need some cash to get going and need more money as they become more successful. They have to invest in staff, equipment and websites, and need to remain competitive and visible by keeping products and services up to date.

Many sources of funds are available to businesses, both big and small. However, not all of them are equally appropriate to all businesses at all times. Different sources of finance carry very different obligations, responsibilities and opportunities for profitable business. Having some appreciation of these differences enables business people to make informed choices.

Stock Markets

A stock market is quite simply a marketplace for trading company stock. A company listing on the London Stock Exchange, The New York Stock Exchange or FWB Frankfurt Stock Exchange is the way serious players raise money. The new breed of 'super exchanges' such as NYSE Euronext are also becoming popular. If you want a few hundred million, or a billion or so, stock markets are the places to come to.

All the stock markets have different rules and different outcomes. For example, the value placed on new companies on US stock markets is between 1.5 and 3 times that of UK and European markets.

To get listed on a major stock exchange, a company needs a track record of making substantial profits, with decent seven-figure sums being made in the year you plan to *float*, as this process is known. A large proportion (usually at least 25 per cent) of the company's shares must be put up for sale at the outset. Also, companies are expected to have 100 shareholders now and to demonstrate that 100 more will come on board as a result of the listing.

> You can check out all the world stock markets from Amsterdam to Zagreb on the Stock Exchanges Worldwide Links website at `www.tdd.lt/slnews/Stock_Exchanges/Stock.Exchanges.htm` and at `www.worldwide-tax.com/stockexchanges/worldstockexchanges.asp`. Almost all stock exchange websites have pages in English. Look out for a term such as 'Listing Center', 'Listing' or 'Rules' and you'll find the latest criteria for floating a company on that exchange.

Junior stock markets such as London’s Alternative Investment Market (AIM) were formed in the mid to late 1990’s specifically to provide risk capital for new rather than established ventures. These markets have an altogether more relaxed atmosphere than the major exchanges.

These junior markets are an attractive proposition for entrepreneurs seeking equity capital. AIM is particularly attractive to any dynamic company of any size, age or business sector that has rapid growth in mind. The smallest firm on AIM entered to raise less than £1 million and the largest raised over £500 million.

As with the major stock markets, these junior versions expect something in return. The formalities for floating are minimal but the costs of entry are high, and you must have a nominated adviser such as a major accountancy firm, stockbroker or banker. The cost of floating on the junior market is around 6.5 per cent of all funds raised, and companies valued at less than £2 million can expect to shell out a quarter of funds raised in costs alone. The market is regulated by the London Stock Exchange. You can find out more by going to their website (www.londonstockexchange.com) and clicking on ‘AIM’.

One rung down from AIM is PLUS-Quoted Market whose roots lie in the market formerly known as Ofex. It began life in November 2004 and was granted Recognised Investment Exchange (RIE) status by the Financial Services Authority (FSA) in 2007. Aimed at smaller companies wanting to raise up to £10 million, it draws on a pool of capital primarily from private investors. The market is regulated, but requirements aren’t as stringent as those of AIM or the main market and the costs of flotation and ongoing costs are lower. Keycom used this market to raise £4.4 million in September 2008 to buy out a competitor to give them a combined contract to provide broadband access to 40,000 student rooms in UK universities. There are 174 companies quoted on PLUS with a combined market capitalisation of £2.3 billion. Even in 2009, a particularly bad year for stock market activity, 30 companies applied for entry to PLUS and 18 were admitted. You can find out more about PLUS at www.plusmarketsgroup.com.

Private Equity

Organisations known as *venture capitalists* provide private equity by investing other people's money, often from pension funds. They are likely to be interested in investing large sums of money, often more than can be raised on AIM. Some 7,000 or so companies worldwide get private equity backing each year, around half of which are in the US where the average deal is $7.8 million.

Venture capitalists generally expect their investment to pay off within seven years, but they are hardened realists. Two in every ten investments they make are total write-offs, and six perform averagely well at best. So, the one star in every ten investments they make has to cover a lot of duds. Venture capitalists have a target rate of return of over 30 per cent, to cover this poor hit rate.

Raising venture capital is an expensive option and deals are slow to arrange. Six months is not unusual, and over a year has been known. Every venture capitalist has a deal done in six weeks in its portfolio, but that truly is the exception rather than the rule.

PricewaterhouseCoopers produce the Money Tree Report (www.pwcmoneytree.com), which is a quarterly study of venture capital investment activity in the United States, and individual country associations do something similar for their own markets. The PSEPS Venture Capital and Private Equity Directory (www.pseps.com/associations.php) lists the venture capital associations of various countries.

The British Venture Capital Association (www.bvca.co.uk), the European Venture Capital Association (www.evca.com) and the National Venture Capital Association (www.nvca.org) in the US have online directories giving details of hundreds of venture capital providers both inside and outside of their respective countries and continents.

You can see how those negotiating with or receiving venture capital rate the firm in question at the Funded website (www.thefunded.com) in terms of the deal offered, the firm's apparent competence and how good they are at managing the relationship.

Business Angels

One possible first source of equity or risk capital is a private individual with his or her own funds and perhaps some knowledge of your type of business. In return for a share in the business, such investors will invest money at their own risk.

About 40 per cent of these individuals suffer a partial or complete loss of their investment, which suggests that many are prepared to take big risks. They've been christened 'business angels', a term first coined to describe private wealthy individuals who backed a play on Broadway or in London's West End.

Most business angels have worked in a small firm or have owned their own businesses before, so know the business world well. They are more likely to invest in early-stage investments where relatively small amounts of money are needed. 10 per cent of business angel investment is for less than £10,000 and 45 per cent is for over £50,000. They are up to five times more likely to invest in start-ups and early-stage investments than venture capital providers in general. Most business angels invest close to home, and syndicated deals make up more than a quarter of all deals, proving that angels flock together!

In return for their investment, most angels want some involvement beyond merely signing a cheque and may hope to play a part in your business in some way. They are looking for big rewards. One angel who backed the fledgling software company Sage (who supply accounting, payroll and business management software for small and medium sized companies) with £10,000 in its first round of £250,000 financing saw his stake rise to £40 million. Various industry estimates suggest that upwards of £6.5 billion of angels' money is looking for investment homes, although the sum actually invested each year is probably much smaller than that.

To find a business angel, check out the online directory of the British Business Angels Association (www.bbaa.org.uk). The European Business Angels Network website has directories of national business angel associations both inside and outside of Europe. Go to www.eban.org and click on ‘Members’ to find individual business angels.

Corporate Venture Funds

Venture capital firms often get their hands dirty taking a hand in the management of the businesses they invest in. Another type of business is also in the risk capital business, without it necessarily being their main line of business. These firms, known as *corporate venturers*, usually want an inside track to new developments in and around the edges of their own fields of interest.

Sinclair Beecham and Julian Metcalfe founded takeaway food chain Pret a Manger with a £17,000 loan and a name borrowed from a boarded-up shop. They had global ambitions and they joined forces with the corporate venturing arm of a big firm. It was only by cutting in McDonald's, the burger giant, that they could see any realistic way to dominate the world. They sold a 33% stake for £25 million in 2001 to McDonald's Ventures, LLC, a wholly-owned subsidiary of McDonald's Corporation, the arm of McDonalds that looks after its corporate venturing activities. They could also have considered Cisco, Apple Computers, IBM and Microsoft who also all have corporate venturing arms.

For an entrepreneur, corporate venture funds can provide a 'friendly customer' and help to open doors. For the 'parent' it provides a privileged ring-side seat as a business grows and so be able to decide if the area is worth plunging into more deeply, or at least gain valuable insights into new technologies or business processes.

Global Corporate Venturing (www.globalcorporateventuring.com) is a new website devoted to publishing information on who's who and who's doing what in the sector.

Banks

Banks are the principal, and frequently the only, source of finance for businesses that are not listed on a stock market or that don't have private equity backers.

For long-term lending, banks can provide term loans for a number of years, with either a variable interest rate payable or an interest rate fixed for a number of years ahead. The proportion of fixed-rate loans has increased from a third of all term loans to around one in two. In some cases, moving between a fixed interest rate and a variable one at certain intervals may be possible. Unlike in the case of an overdraft, the bank cannot pull the rug from under you if circumstances (or the local manager) change.

Bankers look for asset security to back their loan and to provide a near-certainty of getting their money back. They also charge an interest rate that reflects current market conditions and their view of the risk level of the proposal.

Bankers like to speak of the 'five Cs' of credit analysis – factors they look at when they evaluate a loan request.

- **Character.** Bankers lend money to borrowers who appear honest and who have a good credit history. Before you apply for a loan, obtain a copy of your credit report and clean up any problems.

  You can check out your own business credit rating at CheckSure (www.checksure.biz). By using the comparative ratios for your business sector you can see how to improve your own rating. The service costs around £6 to £10 depending on the level of detail you require.

- **Capacity.** This is a prediction of the borrower's ability to repay the loan. For a new business, bankers look at the business plan. For an existing business, bankers consider financial statements and industry trends.

- **Collateral.** Bankers generally want a borrower to pledge an asset that can be sold to pay off the loan if the borrower lacks funds.

- **Capital.** Bankers scrutinise a borrower's net worth, the amount by which assets exceed debts.
- **Conditions.** Whether bankers give a loan can be influenced by the current economic climate as well as by the amount.

You can see an A to Z listing of business bank accounts at www.find.co.uk/commercial/commercial_banking_centre/business-banking where the top six or so are rated and reviewed.

Governments around the world have schemes to make raising money from banks easier for small and new businesses. These *Small Firm Loan Guarantee Schemes* are operated by banks at the instigation of governments. They are aimed at small and new businesses with viable business proposals that have tried and failed to obtain a conventional loan because of a lack of security. Loans are available for periods of between two and ten years on sums from £5,000 to £250,000. The government guarantees 70–90 per cent of the loan. In return for the guarantee, the borrower pays a premium of 1–2 per cent per year on the outstanding amount of the loan. The commercial aspects of the loan are matters between the borrower and the lender.

You can find out more about the UK Small Firms Loan Guarantee Scheme on the Business Link website (go to www.businesslink.gov.uk and click on 'Finance and grants', 'Finance options, 'Borrowing', and 'Government lending schemes').

As a means of short-term borrowing, banks can offer *overdrafts* – a facility to cover you when you want to withdraw more money from a bank account than it has funds available. The overdraft was originally designed to cover the timing differences of, say, having to acquire raw materials to manufacture finished goods that are later sold. However, overdrafts have become part of the core funding of most businesses, with a little over a quarter of all bank finance provided in this way.

Almost every type and size of business uses overdrafts. They are very easy to arrange and take little time to set up. That is also their inherent weakness. The key words in the arrangement document are *repayable on demand*, which leaves the bank free to make and change the rules as it sees fit. (This term is under constant review, and some banks may remove it from the arrangement.) With other forms of borrowing, as long as you stick to the terms and conditions, the loan is yours for the duration, but not with overdrafts. Small businesses can expect to pay interest at three to four per cent above base – the rate at which banks can borrow. Larger and more creditworthy firms may pay much less.

Bonds, Debentures and Mortgages

Bonds, debentures and mortgages are all kinds of borrowing with different rights and obligations for the parties concerned. A mortgage is much the same for a business as for an individual. The loan is for buying a particular property asset such as a factory, office or warehouse. Interest is payable and the loan itself is secured against the property, so if the business fails, the mortgage can substantially be redeemed.

Companies wanting to raise funds for general business purposes, rather than a mortgage where a particular property is being bought, issue debentures or bonds. These run for a number of years, typically three years and upwards, with the bond or debenture holder receiving interest over the life of the loan with the capital returned at the end of the period.

The key difference between debentures and bonds lies in their security and ranking. Debentures are unsecured, so in the event of the company being unable to pay interest or repay the sum, the loaner may well get little or nothing back. Bonds are secured against specific assets and so rank ahead of debentures for any pay out.

Unlike bank loans that are usually held by the issuing bank, bonds and debentures are sold to the public in much the same way as shares. The interest demanded is a factor of the prevailing market conditions and the financial strength of the borrower.

You can find out more about raising these forms of finance on the Business Link website (www.businesslink.gov.uk).

Leasing and Hire-Purchase

You can usually finance physical assets such as cars, vans, computers and office equipment by leasing them or buying them on hire purchase. This leaves other funds free to cover the less tangible elements in your cash flow. In this way, a business gets the use of assets without paying the full cost all at once.

Companies take out *operating leases* where you use the equipment for less than its full economic life, as you might with a motor vehicle, for example. The lessor takes the risk of the equipment becoming obsolete, and assumes responsibility for repairs, maintenance and insurance. As you, the lessee, pay for this, the service is more expensive than a *finance lease*, where you lease the equipment for most of its economic life, taking care of the maintenance and insurance yourself. Leases can normally be extended, often for fairly nominal sums, in the latter years.

Businesses that need lots of fixed assets such as computers, machinery or vehicles are the big customers for leasing. The obvious attraction of leasing is that you need no deposit, which leaves your working capital free for more profitable use elsewhere. Also, you know the cost from the start, making forward planning simpler. Tax advantages over other forms of finance may even exist.

Hire purchase differs from leasing in that you have the option to eventually become the owner of the asset, after you make a series of payments.

You can find a leasing or hire purchase company through the Finance and Leasing Association. Their website (go to www.fla.org.uk and click on 'For Businesses' and 'Business Finance Directory') gives details of all UK-based businesses that offer this type of finance. The website also has general information on terms of trade and code of conduct. Euromoney produce an annual World Leasing Yearbook that contains details about 4,250 leasing companies worldwide (go to their website at www.euromoney.com and click on 'Leasing & Asset Finance' and 'Books' for ordering information). You can, however, see a listing of most countries' leasing associations for free in the 'Contributors' listing on this site.

Factoring and Invoice Discounting

Customers take on average around 60 to 90 days to pay their suppliers. In effect, this means that companies are granting a loan to customers for that time. In periods of rapid growth, this can put a strain on cash flow. One way to alleviate that strain is to *factor* creditworthy customers' bills to a financial institution and receive some of the funds as goods leave the door, and this speeds up the cash flow.

Factoring is an arrangement that allows a business to receive up to 80 per cent of the cash due from customers more quickly than normal. The factoring company in effect buys the trade debts, provides a 100 per cent protection against bad debts and can also provide a debtor accounting and administration service.

Factoring costs a little more than normal overdraft rates. The factoring service costs between 0.5 and 3.5 per cent of the turnover, depending on volume of work, the number of debtors, average invoice amount and other related factors.

Factoring is generally only available to a business that invoices other business customers for services provided. These customers can be either in the business's home market or overseas. Companies that sell directly to the public, sell complex and expensive capital equipment, or expect progress payments on long-term projects may find factoring their debtor book to be difficult, if not impossible.

Invoice discounting is a variation on the same theme. Factors collect in money owed by their clients' customers, take a fee and pass the balance on, whereas invoice discounters leave their clients to collect the money themselves. This could be an advantage for firms that fear the factoring method might reduce their contact with clients. Invoice discounting is, in any case, typically available only to businesses with a turnover in excess of £1 million.

You can find an invoice discounter or factoring business through the Asset Based Finance Association's directory at www.thefda.org.uk/public/membersList.asp.

Grants, Incentives and Competitions

Surprisingly, there really is such a thing as a free lunch in the money world. These free lunches come from benevolent governments whose agenda is either to get businesses to locate in an area bereft of business but jammed full of people looking for work, or to pioneer new, unproven and risky technologies.

Absolutely no evidence exists that governments get any value out of this generosity, but that's the thing with governments – they feel they have to *govern*, and people are more prepared to listen to others that have open wallets.

Grants are constantly being introduced (and withdrawn), but no system exists to let you know automatically. You have to keep yourself informed. The Business Link website (go to www.businesslink.gov.uk and click on 'Finance and grants' and 'Grants and government support') has advice on how to apply for a grant as well as a directory of grants on offer. The Microsoft Small Business Centre (www.microsoft.com/uk/businesscentral/euga/home.aspx) has a European Union Grant Advisor with a search facility to help you find which of the 6,000 grants on offer might suit your business needs. www.grants.gov is a guide to how to apply for over 1,000 federal government grants in the US.

Governments aren't the only guys with open wallets. More than a thousand annual awards around the world aimed at businesses exist. They are awarded for such achievements as being the greenest, cleanest, fastest (growing, that is), best company to work for and a thousand other plausible superlatives to make you feel good. The guys giving these awards are in it for the publicity, and heck, if you can get your hands on some free money, swallow your pride and head on down. Business plans are central to most of these competitions, which are sponsored by banks, the major accountancy bodies, chambers of commerce, local or national newspapers, business magazines and the trade press. Government departments may also have their own competitions as a means of promoting their initiatives for exporting, innovation, job creation and so forth. You can find directories of business plan competitions at www.smallbusinessnotes.com/planning/competitions.html and www.awardsintelligence.co.uk.

Using the Pension Fund

This financing strategy is mostly available to private companies with a relatively limited number of participants – usually directors, partners, top managers and shareholders. In these cases, the company can pay money out of business profits, thus escaping tax, into either a Small Self-Administered Scheme (SSAS) or a Self-Invested Personal Pension Plan (SIPP). That scheme can then invest in a narrow range of asset classes such as the company's own shares, purchase of commercial property and loans to the company, subject to certain conditions and with the approval of the pension trustees. The trustees are themselves regulated by the Pensions Regulator (www.thepensionsregulator.gov.uk). The aim of any pension investment must be to enhance the value of the pension fund for the ultimate benefit of all the pensioners equally.

The fun doesn't stop at being able to use pensioners' money to invest in the business they work in. Both SSAS and SIPP schemes can (since April 2006) borrow up to 50 per cent of their net assets to purchase property. So, if an SSAS/SIPP has total assets of £100,000, it can borrow a further £50,000, thus providing up to £150,000 to invest in qualifying business assets.

You can get the lowdown on SSAS and SIPP pension schemes from companies such as Westerby Trustee Service (www.sipp-ssas-pensions.co.uk) and SIPPS Guide (www.sippsguide.com).

Chapter 18

Ten (Plus One) Questions Investors Should Ask When Reading a Financial Report

In This Chapter

- Analysing sales and profit performance
- Investigating changes in assets and liabilities
- Looking for signs of financial distress
- Examining asset utilisation and return on capital investment

You have only so much time to search for the most important signals in a business's financial report. For a quick read through a financial report – one that allows you to decode the critical signals in the financial statements – you need a checklist of key questions to ask.

Before you read a business's annual financial report, get up to speed on which products and services the business sells and learn about the history of the business and any current problems it's facing. One place to find much of this information is the company's annual accounts filed at Companies House, which is a public document available to everyone. (You can also usually find this information on the company's website, in the investor affairs section.) Company profiles are prepared by securities brokers and investment advisers, and they're very useful. *The Economist*, *Investors Chronicle* and other national newspapers, such as *The Financial Times*, are good sources of information about public companies.

Did Sales Grow?

A business makes profit by making sales (although you do have to take controlling expenses into account). Sales growth is the key to long-run sustained profit growth. Even if profit is up, investors get worried when sales revenue is flat.

Start reading a financial report by comparing this year's sales revenue with last year's, and with all prior years included in the financial report. A company's sales trend is the most important factor affecting its profit trend. We dare you to find a business that has had a steady downward sales trend line but a steady upward profit line – you'd be looking for a long time.

Did the Profit Ratios Hold?

Higher sales from one year to the next don't necessarily mean higher profit. You also need to look at whether the business was able to maintain its profit ratio at the higher sales level. Recall that the *profit ratio* is net income divided by sales revenue. If the business earned, say, a 6 per cent profit ratio last year, did it maintain or perhaps improve this ratio on its higher sales revenue this year?

Also compare the company's *gross margin ratios* from year to year. Cost-of-goods-sold expense is reported by companies that sell products. Recall that gross margin equals sales revenue less cost of goods sold. Any significant slippage in a company's gross margin ratio (gross margin divided by sales revenue) is a very serious matter. Suppose that a company gives up two or three points (one point = 1 per cent) of its gross margin ratio. How can it make up for this loss? Decreasing its other operating expenses isn't easy or very practical – unless the business has allowed its operating expenses to become bloated.

In most external financial reports, profit ratios are *not* discussed openly, especially when things have not gone well for the business. You usually have to go digging for these important ratios and use your calculator. Articles in the financial press on the most recent earnings of public corporations focus on gross margin and profit ratios – for good reason. We always keep an eye on profit as a percentage of sales revenue, even though we have to calculate this key ratio for most businesses. We wish that all businesses would provide this ratio.

Were There Any Unusual or Extraordinary Gains or Losses?

Every now and then, a business records an *unusual* or *extraordinary* gain or loss. The first section of the profit and loss account reports sales revenue and the expenses of making the sales and operating the business. Also, interest and income tax expenses are deducted. Be careful: The profit down to this point may *not* be the final bottom line. The profit down to this point is from the business's ongoing, normal operations before any unusual, one-time gains or losses are recorded. The next layer of the profit and loss account reports these extraordinary, non-recurring gains or losses that the business recorded during the period.

These gains or losses are called extraordinary because they do not recur – or at least should not recur, although some companies report these gains and losses on a regular basis. These gains and losses are caused by a *discontinuity* in the business – such as a major organisational restructuring involving a reduction in the workforce and paying substantial severance packages to laid-off employees, selling off major assets and product lines of the business, retiring a huge amount of debt at a big gain or loss, or settling a huge lawsuit against the business. Generally, the gain or loss is reported on one line net of the corporation tax effect for each extraordinary item, and a brief explanation can be found in the footnotes to the financial statements.

Investors have to watch the pattern of these items over the years. An extraordinary gain or loss now and then is a normal part of doing business and is nothing to be alarmed about. However, a business that reports one or two of these gains or losses every year or every other year is suspect. These gains or losses may be evidence of past turmoil and future turbulence. We classify these businesses as high-risk investments – because you don't know what to expect in the future.

In any case, we advise you to consider whether an unusual loss is the cumulative result of inadequate accounting for expenses in previous years. A large legal settlement, for example, may be due to the business refusing to admit that it is selling unsafe products year after year; its liability finally catches up with it.

Did Earnings Per Share Keep Up with Profit?

Chapter 14 explains that a publicly owned business with a simple capital structure – meaning that the business is not required to issue additional shares in the future – reports just one earnings per share (EPS) for the period, which is called *basic* EPS. You calculate basic EPS by using the actual number of shares owned by shareholders. However, many publicly owned businesses have complex capital structures that require them to issue additional shares in the future. These businesses report *two* EPS numbers – basic EPS and *diluted* EPS. The diluted EPS figure is based on a larger number of shares that includes the additional number of shares that will be issued under terms of management share options, convertible debt and other contractual obligations that require the business to issue shares in the future.

In analysing earnings per share, therefore, you may have to put on your bifocals, as it were. For many businesses, you have to look at both basic EPS and diluted EPS. We suppose you could invest only in companies that report only basic EPS, but this investment strategy would eliminate a large number of businesses from your stock investment portfolio. Odds are, your stock investments include companies that report both basic and diluted EPS. The two EPS figures may not be too far apart, but then again, diluted EPS may be substantially less than basic EPS for some businesses.

Suppose you own stock in a public corporation that reports bottom-line net income that is 10 per cent higher than last year's. So far, so good. But you know that the market price of your shares depends on earnings per share (EPS). Ask what happened to basic and diluted EPS. Did both EPS figures go up 10 per cent? Not necessarily – the answer is often 'no', in fact. You have to check.

Public companies whose shares are traded on one of the national stock exchanges (London Stock Exchange, New York Stock Exchange, NASDAQ and so on) are required to report EPS in their profit and loss accounts, so you don't have to do any computations. (Private businesses whose shares are not traded do not have to report EPS.)

EPS increases exactly the same percentage that net income increases only if the total number of shares remains constant. Usually, this is not the case. Many public corporations have a fair amount of activity in their shares during the year. So they include a schedule of changes in shareholders' equity during the year. (Chapter 8 discusses this financial summary of changes in shareholders' equity.) Look at this schedule to find out how many shares were issued during the year. Also, companies may purchase some of their own shares during the year, which is reported in this schedule.

Suppose net income increased, say, 10 per cent, but basic EPS increased only 6.8 per cent because the number of shares issued by the business increased 3 per cent during the year. (You can check the computation if you like.) You should definitely look into why additional shares were issued. And if diluted EPS does not keep pace with the company's earnings increase, you should pinpoint why the number of shares included in the calculation of diluted EPS increased during the period. (Maybe more management share options were awarded during the year.) The number of shares may increase again next year and the year after. Businesses do not comment on why the percentage change in their EPS is not the same as the percentage change in their net income. We wish that companies were required to leave a clear explanation of any difference in the percentage of change in EPS compared with the percentage of change in net income. However, this is just wishful thinking on our part. You have to ferret out this information yourself, which we advise you to do.

An increase in EPS may not be due entirely to an increase in net income, but rather to a *decrease* in the number of shares. Cash-rich companies often buy their shares to reduce the total number of shares that is divided into net income, thereby increasing basic and diluted EPS. You should pay close attention to increases in EPS that result from decreases in the number of shares. The long-run basis of EPS growth is profit growth, although a decrease in the number of shares helps EPS and, hopefully, the market price of the shares.

Did the Profit Increase Generate a Cash Flow Increase?

Increasing profit is all well and good, but you also should ask: Did *cash flow from profit* increase? Cash flow from profit is found in the first section of the cash flow statement, which is one of the three primary financial statements included in a financial report. The cash flow statement begins with an explanation of cash flow from profit.

Accountants use the term *cash flow from operating activities* – which, in our opinion, is not nearly as descriptive as *cash flow from profit*. The term *profit* is avoided like the plague in external financial reports; it’s not a politically correct word. So you may think that accountants would use the phrase *cash flow from net income*. But no, the official pronouncement on the cash flow statement mandated the term *cash flow from operating activities*. *Operating activities* refers simply to sales revenue and expenses, which are the profit-making operations of a business. We’ll stick with *cash flow from profit* – please don’t report us to the accounting authorities.

Almost all expenses are bad for cash flow, except one: depreciation. Depreciation expense is actually good for cash flow. Each year, a business converts part of the cost of its fixed assets back into cash through the cash collections from sales made during the year. Over time, fixed assets are gradually used up, so each year is charged with part of the fixed assets' cost by recording depreciation expense. And each year, a business retrieves cash for part of the cost of its fixed assets. Thus depreciation expense decreases profit but increases cash flow. But net income plus depreciation does not equal cash flow from profit – except in the imaginary scenario in which all the company's other operating assets (mainly debtors and stock) and all its operating liabilities (mainly creditors and accrued expenses payable) don't increase or decrease during the year.

Here's the key question: Should cash flow from profit change about the same amount as net income changed, or is it normal for the change in cash flow to be higher or lower than the change in net income?

As a general rule, sales growth penalises cash flow from profit in the short run. A business has to build up its debtors and stock, and these increases hurt cash flow – although, during growth periods, a business also increases its creditors and accrued expenses payable, which helps cash flow. The asset increases, in most cases, dominate the liability increases, and cash flow from profit suffers.

We strongly advise you to compare cash flow from operating activities (see, we use the officially correct term here) with net income for each of the past two or three years. Is cash flow from profit about the same percentage of net income each year? What does the trend look like? For example, last year, cash flow from profit may have been 90 per cent of net income, but this year it may have dropped to 50 per cent. Don't hit the panic button just yet.

A dip in cash flow from profit in one year actually may be good from the long-run point of view – the business may be laying a good foundation for supporting a higher level of sales. But then again, the slowdown in cash flow from profit could present a short-term cash problem that the business has to deal with.

A company's cash flow from profit may be a trickle instead of a stream. In fact, cash flow from profit could be *negative*; in making a profit, the company could be draining its cash reserves. Cash flow from profit is low, in most cases, because debtors from sales haven't been collected and because the business has made large increases in its inventories. These large increases raise questions about whether all the receivables will be collected and whether all the stock will be sold at regular prices. Only time can tell. But generally speaking, you should be cautious and take the net income number that the business reports with a grain of salt.

Analysing cash flow from *loss* (instead of from profit) is very important. When a company reports a loss for the year – instead of a profit – an immediate question is whether the company's cash reserve will buy it enough time to move out of the loss column into the profit column. When a business is in a loss situation (the early years of a start-up business, for example) and its cash flow from operating activities is negative, focus on the company's cash balance and how long the business can keep going until it turns the corner and becomes profitable. Stock analysts use the term *burn rate* to refer to how much cash outflow the business is using up each period. They compare this measure of how much cash the business is haemorrhaging each period to its present cash balance. The key question is this: Does the business have enough cash on hand to tide it over until it starts to generate positive cash flow from profit, and if not, where will it get more money to burn until it can record a profit?

Are Increases in Assets and Liabilities Consistent with the Business's Growth?

Publicly owned businesses present their financial statements in a three-year comparative format (or sometimes a two-year comparative format). Strictly speaking, you don't have to provide comparative financial statements – although all businesses, private and public, are encouraged to present comparative financial statements. Furthermore, business investors and lenders demand comparative financial statements. Thus, three columns of numbers are reported in profit and loss accounts, balance sheets and cash flow statements – for the current and two preceding years. To keep financial statement illustrations in this book as brief as possible, we present only one year; we do not include two additional columns for the two previous years. Please keep this point in mind.

Presenting financial statements in a three-year comparative format, as may be obvious, helps the reader make year-to-year comparisons. Of course, you have to deal with three times as many numbers in a three-year comparative financial statement compared with a one-year financial statement. And we should point out that the *amounts of changes* are not presented; you either eyeball the changes or use a calculator to compute the amounts of changes during the year. For example, the ending balances of a business's property, plant and equipment asset account may be reported as follows (in millions of pounds): £4,097, £4,187 and £3,614 for the last three fiscal years. Only these ending balances are presented in the company's comparative balance sheet – the increase or decrease during the year is not presented.

A three-year comparative format enables you to see the general trend of sales revenue and expenses from year to year and the general drift in the amounts of the company's assets, liabilities and owners' equity accounts. You can easily spot any major differences in each line of the cash flow statement across the years. Whether you just cast a glance at adjacent amounts or actually calculate changes, ask yourself whether the increases of a company's assets and liabilities reported in its balance sheet are consistent with the sales growth of the business from year to year.

Unusually large increases in assets that are greatly out of line with the company's sales revenue growth put pressure on cash flow and could cast serious doubts on the company's solvency – which we explain in the next section.

Can the Business Pay Its Liabilities?

A business can build up a good sales volume and have very good profit margins, but if the company can't pay its bills on time, its profit opportunities could go down the drain. *Solvency* refers to the prospects of a business being able to meet its debt and other liability payment obligations on time. Solvency analysis asks whether a business will be able to pay its liabilities, looking for signs of financial distress that could cause serious disruptions in the business's profit-making operations. In short, even if a business has a couple of billion quid in the bank, you should ask: How does its solvency look?

To be solvent doesn't mean that a business must have cash in the bank equal to its total liabilities. Suppose, for example, that a business has £2 million in non-interest-bearing operating liabilities (mainly creditors and accrued expenses payable), £1.5 million in overdraft (due in less than one year) and £3.5 million in long-term debt (due over the next five years). Thus, its total liabilities are £7 million. To be solvent, the business does not need £7 million in its bank account. In fact, this would be foolish.

There's no point in having liabilities if all the money were kept in the bank. The purpose of having liabilities is to put the money to good use in assets other than cash. A business uses the money from its liabilities to invest in *non-cash* assets that it needs to carry on its profit-making operations. For example, a business buys products on credit and holds these goods in stock until it sells them. It borrows money to invest in its fixed assets.

Solvency analysis asks whether assets can be converted quickly back into cash so that liabilities can be paid on time. Will the assets generate enough cash flow to meet the business's liability payment obligations as they come due?

Short-term solvency analysis looks a few months into the future of the business. It focuses on the *current* assets of the business in relation to its *current* liabilities; these two amounts are reported in the balance sheet. A rough measure of a company's short-term liability payment ability is its *current ratio* – current assets (cash, debtors, stock and prepaid expenses) are divided by current liabilities (creditors and accrued expenses payable, plus interest-bearing debt coming due in the short term). A 2-to-1 current ratio usually is a reasonable benchmark for a business – but don't swallow this ratio hook, line and sinker.

> A 2-to-1 current ratio is fairly conservative. Many businesses can get by on a lower current ratio without alarming their sources of short-term credit.

Business investors and creditors also look at a second solvency ratio called the *quick ratio*. This ratio includes only a company's *quick assets* – cash, debtors and short-term marketable investments in other company shares (if the company has any).

Quick assets are divided by current liabilities to determine the quick ratio. It’s also called the *acid-test ratio* because it’s a very demanding test to put on a business. More informally, it’s called the *pounce ratio*, as if all the short-term creditors pounced on the business and demanded payment in short order.

Many people consider a safe acid-test ratio to be 1-to-1 – $1 of quick assets for every $1 of current liabilities. However, be careful with this benchmark. It may not be appropriate for businesses that rely on heavy short-term debt to finance their inventories. For these companies, it’s better to compare their quick assets with their quick liabilities and exclude their short-term notes payable that don’t have to be paid until stock is sold.

The current and acid-test ratios are relevant. But the solvency of a business depends mainly on the ability of its managers to convince creditors to continue extending credit to the business and renewing its loans. The credibility of management is the main factor, not ratios. Creditors understand that a business can get into a temporary bind and fall behind on paying its liabilities. As a general rule, creditors are slow to pull the plug on a business. Shutting off new credit may be the worst thing lenders and other creditors could do. This may put the business in a tailspin, and its creditors may end up collecting very little. Usually, it’s not in their interest to force a business into bankruptcy, except as a last resort.

Also check out the gearing. If borrowings are growing faster than retained profits or new shareholder investments, then gearing is going up, as are the financing risks. Have a look at Chapter 14 to see what gearing/leverage is all about.

Are There Any Unusual Assets and Liabilities?

Most businesses report a miscellaneous, catch-all account called *other assets*. Who knows what might be included in here? If the balance in this account is not very large, trust that the auditor did not let the business bury anything important in this account.

Marketable securities is the asset account used for investments in shares and bonds (as well as other kinds of investments). Companies that have more cash than they need for their immediate operating purposes put the excess funds to work earning investment income rather than let the money lie dormant in a bank checking account. The accounting rules for marketable securities are fairly tight; you needn't be concerned about this asset.

If you encounter an asset or liability you're not familiar with, look in the footnotes to the financial statements, which present a brief explanation of what the accounts are and whether they affect profit accounting. (We know, you don't like reading footnotes; neither do we.) For example, many businesses have large liabilities for unfunded pension plan obligations for work done in the past by their employees. The liability reveals that the business has recorded this component of labour expense in determining its profit over the years. The liability could be a heavy demand on the future cash flow of the business.

How Well Are Assets Being Utilised?

The overall test of how well assets are being used is the *asset turnover ratio*, which equals annual sales revenue divided by total assets. (You have to calculate this ratio; most businesses do not report this ratio in their financial statements, although a minority do.) This ratio tests the efficiency of using assets to make sales. Some businesses have low asset turnover ratios, less than 2-to-1. Some have very high ratios, such as 5-to-1. Each industry and retail sector in the economy has a standard asset turnover ratio, but these differ quite a bit from industry to industry and from sector to sector. There is no standard asset turnover ratio for all businesses. A supermarket chain couldn't make it if its annual sales revenues were only twice its assets. Capital-intensive heavy manufacturers, on the other hand, would be delighted with a 2-to-1 asset turnover ratio.

TIP

Financial report readers are wise to track a company's asset turnover ratio from year to year. If this ratio slips, the company is getting less sales revenue for each pound of assets. If the company's profit ratio remains the same, it gets less profit out of each pound of assets, which is not good news for equity investors in the business.

What Is the Return on Capital Investment?

We need a practical example to illustrate the *return on capital investment* questions you should ask. Suppose a business has £12 million total assets, and its creditors and accrued liabilities for unpaid expenses are £2 million. Thus, its *net operating assets* – total assets less its non-interest-bearing operating liabilities – are £10 million. We won't tell you the company's sales revenue for the year just ended. But we will tell you that its earnings before interest and tax (EBIT) were £1.32 million for the year. The basic question you should ask is this: How is the business doing in relation to the total capital used to make this profit?

EBIT is divided by assets (net operating assets, in our way of thinking) to get the *return on assets (ROA)* ratio. In this case, the company earned 13.2 per cent ROA for the year just ended:

> £1,320,000 EBIT ÷ £10,000,000 net operating assets = 13.2% ROA

Was this rate high enough to cover the interest rate on its debt? Sure; it's doubtful that the business had to pay a 13.2 per cent interest rate. Now for the bottom-line question: How did the business do for its *owners*, who have a lot of capital invested in the business?

The business uses £4 million total debt, on which it pays 8 per cent annual interest. Thus, its total owners' equity is £6 million. The business is organised as a company that pays, for example, 30 per cent tax on its taxable income.

Given the company's capitalisation structure, its EBIT (or profit from operations) for the year just ended was divided three ways:

- **£320,000 interest on debt:** £4,000,000 debt × 8 per cent interest rate = £320,000

- **£300,000 income tax:** £1,320,000 EBIT – £320,000 interest = £1,000,000 taxable income; £1,000,000 taxable income × 30 per cent tax rate = £300,000 income tax
- **£700,000 net income:** £1,320,000 operating earnings – £320,000 interest – £300,000 income tax = £700,000 net income

Net income is divided by owners' equity to calculate the *return on equity (ROE)* ratio, which in this example is

£700,000 net income ÷ £6,000,000 owners' equity = 12% ROE

Some businesses report their ROE ratios, but many don't – generally accepted accounting principles don't require the disclosure of ROE. In any case, as an investor in the business, would you be satisfied with a 12 per cent return on your money?

You made only 4 per cent more than the debt holders, which may not seem much of a premium for the additional risks you take on as an equity investor in the business. But you may predict that the business has a bright future and over time your investment will increase two or three times in value. In any case, ROE is a good point of reference – although this one ratio doesn't give you a final answer regarding what to do with your capital. Reading Tony Levene's *Investing For Dummies* (Wiley) can help you make a wise decision.

What Does the Auditor Say?

A business pays a lot of money for its audit, and you should read what the auditor has to say. We'll be frank: The wording of the auditor's report is tough going. Talk about jargon! In any case, focus on the sentence that states the auditor's *opinion* on the financial statements. In rough terms, the auditor gives the financial statements a green light, a yellow light or a red light – green meaning that everything's okay (as far as can be ascertained by the process of the audit), yellow meaning that you should be aware of something that prevents the auditor from giving a green light and red meaning that the financial statements are seriously deficient.

Look for the key words *true and fair*. These code words mean that the audit firm has no serious disagreement with how the business prepared its financial statements. This unqualified opinion is called a *clean opinion*. Only in the most desperate situations does the auditor give an adverse opinion, which in essence says that the financial statements are misleading. If the audit firm can't give a clean opinion on the financial statements or thinks that something about the financial statements should be emphasised, a fourth paragraph is added to the standard three-paragraph format of the audit report (or additional language is added to the one-paragraph audit report used by the big accountancy firm PricewaterhouseCoopers). The additional language is the tip-off; look for a fourth paragraph (or additional language), and be sure to read it. The auditor may express doubt about the business being able to continue as a going concern. The solvency ratios discussed earlier should have tipped you off. When the auditor mentions it, things are pretty serious.

Chapter 19

Ten Ways to Get a Better Handle on the Financial Future

In This Chapter

- Appreciating the difference between forecasts and objectives
- Putting your maths to work
- Unravelling the reasons for trends
- Getting at the real facts
- Keeping projections current
- Building in assumptions

Managers are accustomed to using accounting to unravel the past. Accounts are usually a record of the effect of last year's, month's or week's decisions. Did your strategies for collecting money from customers more quickly or reducing stock levels actually happen, and if so, did they deliver better profits? (We cover this area in Chapter 6.)

But the past, as the saying goes, is another country. The future is where reputations are made and promotion achieved. Managers get maximum value from their grasp of accounting and finance from being able to blend that knowledge with some related skills to get a better handle on the ground ahead.

Sales Forecasts versus Sales Objectives

Sales drive much of a business's activities; they determine cash flow, stock levels, production capacity and ultimately how profitable or otherwise a business is. So, unsurprisingly, much effort goes into attempting to predict future sales. A sales forecast isn't the same as a sales objective. An *objective* is what you want to achieve and will shape a strategy to do so. A *forecast* is the most likely future outcome given what has happened in the past and the momentum that provides for the business.

A forecast is made up of three components and to get an accurate forecast you need to use the historic data to better understand the impact of each on the end result:

- **Underlying trend:** This is the general direction – up, flat or down – over the longer term, showing the rate of change.
- **Cyclical factors:** These are the short-term influences that regularly superimpose themselves on the trend. For example, in the summer months you expect sales of swimwear, ice cream and suntan lotion, to be higher than in the winter. Ski equipment would follow a reverse pattern.
- **Random movements:** These are irregular, random spikes up or down caused by unusual and unexplained factors.

Dealing with Demand Curves

The price you charge for your goods and services is perhaps the single most important number in the financial firmament. Predictions about what price to set influences everything from the amount of materials you have to buy to achieve a given level of profit (the higher the price, the less you have to purchase), to the amount of money you have to invest in fixed assets (a low price may involve selling a lot more to make a given level of profit, requiring a higher level of productive resources).

The main economic concept that underpins almost the whole subject of pricing is that of the *price elasticity of demand.* The concept itself is simple enough. The higher the price of an item or service, the less of it you're likely to sell. Obviously it's not quite that simple in practice; you also need to consider the number of buyers, their expectations, preference and ability to pay, and the availability of substitute products. Figure 19-1 shows a theoretical demand curve.

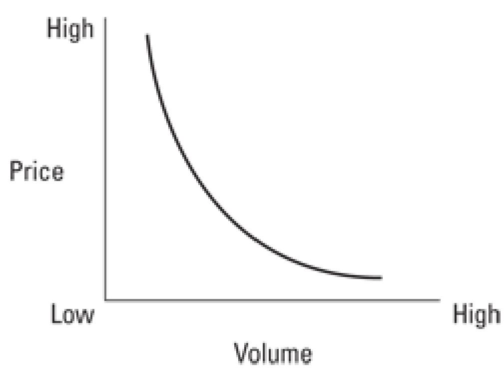


Figure 19-1: The demand curve.

Figure 19-1 shows how the volume of sales of a particular good or service alters with changes in price. You calculate the elasticity of demand by dividing the percentage change in demand by the percentage change in price. If a price is reduced by 50% (say, from £100 to £50) and the quantity demanded increased by 100% (from 1,000 to 2,000), the elasticity of demand co-efficient is 2 (100/50). Here the quantity demanded changes by a bigger percentage than the price change, so demand is considered to be *elastic*. Were the demand in this case to rise by only 25%, then the elasticity of demand coefficient would be 0.5 (25/100). Here the demand is *inelastic*, as the percentage demand change is smaller than that of the price change.

Having a feel for elasticity is important in developing a business's financial strategy, but there's no perfect scientific way to work out what the demand coefficient is; it has to be assessed by 'feel'. Unfortunately the price elasticity changes at different price levels. For example, reducing the price of vodka from £10 to £5 might double sales, but halving it again may not have such a dramatic effect. In fact it could encourage a certain group of buyers, those giving it as a gift for example, to feel that giving something so cheap is rather insulting.

Maths Matters

The simplest way to predict the future is to assume that it will be more or less the same as the recent past. Despite Henry Ford's attributed quote that history is bunk, very often the past is a very good guide to what's likely to happen in the fairly immediate future – far enough ahead for budgeting purposes, if not for shaping long-term strategy.

The three most common mathematical techniques that use this approach are as follows:

- **Moving average** takes a series of data from the past, say, the last six months' sales, adds them up, divides by the number of months and uses that figure as the most likely forecast of what will happen in month seven. This method works well in a static, mature market place where change happens slowly, if at all.

- **Weighted moving average** gives more recent data more significance than earlier data because it gives a better representation of current business conditions. So before adding up the series of data, each figure is weighted by multiplying it by an increasingly higher factor as you get closer to the most recent data.
- **Exponential smoothing** is a more sophisticated averaging technique that gives exponentially decreasing weights as the data gets older. More recent data is given relatively more weight in making the forecasting. You can use double and triple exponential smoothing to help with different types of trend.

Fortunately all you need to know is that these and other statistical forecasting methods exist. The choice of which is the best forecasting technique to use is usually down to trial and error.

TIP

Various software programs calculate the best-fitting forecast by applying each of these techniques to the historic data you enter. See what actually happens and use the forecast technique that's closest to the actual outcome. Professor Hossein Arsham of the University of Baltimore provides a useful tool that enables you to enter data and see how different forecasting techniques perform. (http://home.ubalt.edu/ntsbarsh/Business-stat/otherapplets/ForecaSmo.htm#rmenu)

Duke University's Fuqua School of Business provides a helpful link to all their lecture material on forecasting (www.duke.edu/~rnau/411home.htm).

Averaging Out Averages

A common way forecasts are predicted is around a single figure that purports to be representative of a whole mass of often conflicting data. This single figure is usually known as an *average*, with the process of averaging seen as a way of smoothing over any conflicts. When some customers pay one price and others quite a different one, an average is used as the basis for forecasting. That would be all fine and dandy were it not for the fact that you have three different ways of measuring an average (the mean, median and mode). In fact, averages are the most frequently confused and misrepresented set of numbers in the whole field of forecasting.

To analyse anything for forecasting purposes you first need a data set such as that in Table 19-1.

Table 19-1 The Selling Prices of Company's Products to Different Customers

Customer	*Selling Price (£s)*
1	30
2	40
3	10
4	15
5	10

You then have three ways of working with the numbers:

- **The mean (or average):** This is the most common tendency measure and is used as a rough and ready check for many types of data. In Table 19-1 you add up the prices (£105) and divide by the number of customers (5), to arrive at a *mean*, or average selling price of £21.
- **The median:** The *median* is the value occurring at the centre of a data set. Recasting the figures in Table 19-1 in order puts Customer 4's purchase price of £15 in central position, with two higher and two lower prices. The median comes into its own in situations where the outlying values in a data set are extreme, as they are in the example, where, in fact, most of the customers buy for well below £21. In this case the median is a better measure of the average.

  TIP: Always use the median when the distribution is skewed. You can use either the mean or the median when the population is symmetrical because they'll give very similar results.
- **The mode:** The mode is the observation in a data set that appears the most; in this example it is £10. So if you were surveying a sample of customers you'd expect more of them to say they were paying £10 for the products, even though you know the average price is £21.

Looking for Causes

Often when looking at historic data (the basis of all projections), a relationship between certain factors becomes apparent. Look at Figure 19-2, which is a chart showing the monthly sales of barbeques and the average temperature in the preceding month for the past eight months.

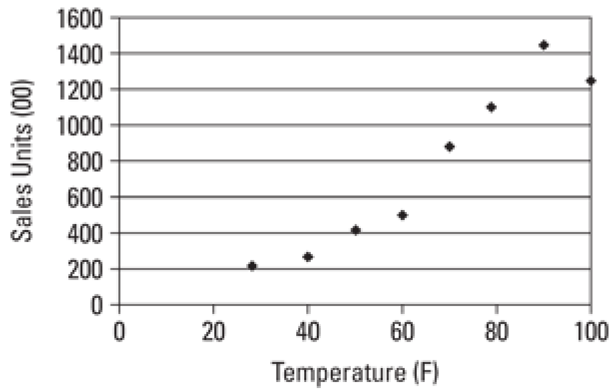


Figure 19-2: Scatter diagram.

You can clearly see a relationship between temperature (the *independent variable*) and sales (the *dependant variable*). By drawing the line that most accurately represents the slope, called the *line of best fit* (see Figure 19-3), you have a useful tool for estimating what sales might be next month, given the temperature that occurred this month.

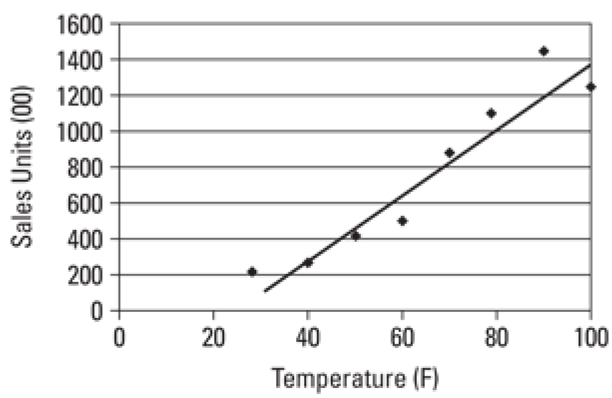


Figure 19-3: Scatter diagram with the line of best fit.

This example is a simple one. Real life data is usually more complicated, so it's harder to see a relationship between the independent and dependant variables with real life data than it is here. Fortunately, an algebraic formula known as *linear regression* can calculate the line of best fit for you.

A couple of calculations can test if a causal relationship is *strong* (even if strongly negative, the test is still useful for predictive purposes) and *significant* – the statisticians way of telling you if you can rely on the data as an aid to predicting the future. The tests are known as *R-Squared* and the *Students t test*, and all you need to know is that they exist and that you can probably find the software to calculate them on your computer.

Try Web-Enabled Scientific Services & Applications' (www.wessa.net/slr.wasp) free software, which covers almost every type of statistic calculation. For help in understanding statistical techniques, read Gerard E. Dallal's book *The Little Handbook of Statistical Practice* available free online (www.tufts.edu/~gdallal/LHSP.HTM). At Princeton University's website you can find a tutorial and lecture notes on the subject as taught to their Master of International Business students (http://dss.princeton.edu/online_help/analysis/interpreting_regression.htm).

Straddling Cycles

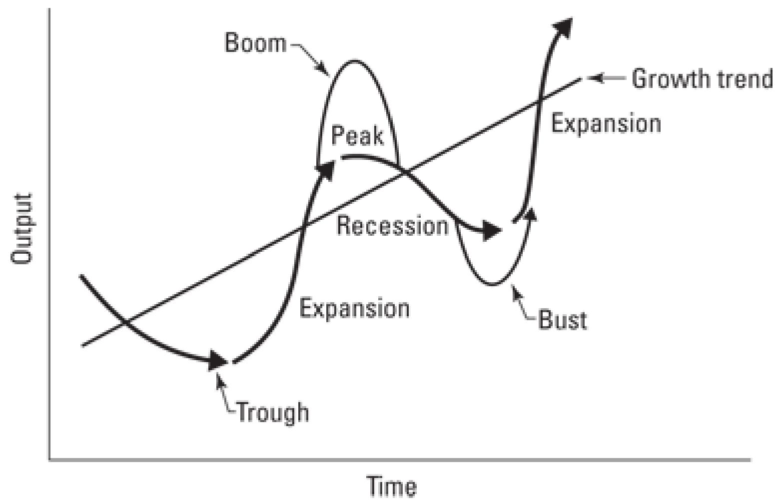
Economies tend to follow a cyclical pattern that moves from *boom*, when demand is strong, to *slump*, economists' shorthand for a downturn. Politicians believe they have become better managers of demand and proclaim the death of the cycle, but the 'this time it's different' school of thinking has been proved wrong time and time again. The cycle itself is caused by the collective behaviour of billions of people – the unfathomable 'animal spirits' of businesses and households. Maynard Keynes, the British economist whose strategy of encouraging governments to step up investment in bad times did much to alleviate the slump in the 1930s, explained animal spirits in the following way: 'Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities'.

Added to the urge to act is the equally inevitable herd-like behaviour that leads to excessive optimism and pessimism. From the tulip mania in 17th-century Holland and the South Sea Bubble (1711–1720), to the Internet Bubble in 1999 and the collapse in US real estate in 2008, the story behind each bubble has been uncomfortably familiar. Strong market demand for some commodity (such as gold, copper or oil), currency, property or type of share leads the general public to believe the trend cannot end. Over-optimism leads the public at large to overextend itself in acquiring the object of the mania, while lenders fall over each other to fan the flames. Finally, either the money runs out or groups of investors become cautious. Fear turns to panic selling, so creating a vicious downward spiral that can take years to recover from.

Economics is a science of the indistinctly knowable rather than the exactly predictable. Although all cycles are difficult to understand or predict with much accuracy, they do have discernable patterns and some distinctive characteristics. Give some consideration to where you think you are in the cycle and build that into your projections.

Figure 19-4 shows an elegant curve, which depicts the theoretical textbook cycle.

Figure 19-4: The textbook economic cycle.



TIP

The National Bureau of Economic Research provides a history of all US business cycle expansions and contractions since 1854 (www.nber.org/cycles.htm). The Foundation for the Study of Cycles, an international research and educational institution, provides a detailed explanation of different cycles (http://foundationforthestudyofcycles.org). The Centre for Growth and Business Cycle Research based in Manchester University's School of Social Sciences provides details of current research, recent publications and downloadable discussion papers on all aspects of business cycles (www.socialsciences.manchester.ac.uk/cgbcr).

Surveying Future Trends

Surveys are the most common research method used in organisations to get a handle on almost every aspect of future demand. If you ask your customers how much they plan to spend on their next holiday, car, haircut or laptop, you have a figure to base your projections on. Leaving aside the practical aspects of preparing and executing surveys (read *Statistics For Dummies* by Deborah J. Rumsey (Wiley) to find out about that), to be sure of the degree to which surveys are likely to be meaningful, you need a modest grasp of maths.

The size of the survey you undertake is vital to its accuracy. You frequently hear of political opinion polls taken on samples of 1,500–2,000 voters. This is because the accuracy of your survey clearly increases with the size of sample, as Table 19-2 shows:

Table 19-2 Survey Accuracy

Size of Sample	*95% of Surveys are Right within this many Percentage Points*
250	6.2
500	4.4
750	3.6
1,000	3.1
2,000	2.2
6,000	1.2

If on a sample size of 500, your survey showed that 40 per cent of your customers plan to spend £1,000 on your products, the true proportion would probably lie between 35.6 and 44.4 per cent. A sample of 250 completed replies is about the minimum to provide meaningful information.

Andrews University in the United States has a free set of lecture notes explaining the subject of sample size comprehensively (www.andrews.edu/~calkins/math/webtexts/prod12.htm). At www.auditnet.org/docs/statsamp.xls you can find some great spreadsheets that do the boring maths of calculating sample size and accuracy for you.

Talking To The Troops

Financial forecasts are usually in the domain of top management and senior staff such as CFOs. However all the decisions that have a direct bearing on these forecasts rely on information provided by people on the front line. They know where the bodies are, so it makes good sense to talk to them early in the planning process. Also, you need their commitment because chances are they'll have a big influence on whether your projections bear fruit.

This process is known as *bottom up* projection. It involves, for example, building up a sales forecast customer by customer for every product or service they buy or may buy. Bottom up projection also requires an estimate of how many customers will be lost and won. Clearly only someone with detailed knowledge can prepare this. You can check this against your top down projection, based on, say, using a sales forecasting technique such as those covered earlier in this chapter. If you find a wide divergence between your theoretical projections and those made by the front line troops, discuss them and come up with a consensus that everyone can buy into.

Setting Out Assumptions

All future projections are based on assumptions – the stage of the economic cycle, government strategies on tax and expenditure, market size and growth rates, the level and type of competition . . . oh yes, and the weather comes into future projections too. The people running Heathrow hadn't expected the last week of 2010 to deliver so much snow it shut the airport just as peak Christmas demand was about to get underway.

Even the environment gets a look in here. Eyjafjallajökull, the Icelandic volcano that erupted in April 2010, caused air traffic around Europe and across the Atlantic to grind to a halt for six days. Airlines lost up to half their annual profits, business passengers were stranded for days and supply chains shortened by just-in-time purchasing strategies dried up. Now, arguably, business could do little directly or immediately to mitigate these problems, but the experience served to demonstrate the interconnection of seemingly remote environmental factors and made more obvious the reasons businesses have to take issues such as climate change seriously. Even if you are in no danger – unlike Lohachara, the first inhabited island to be wiped off the face of the Earth by global warming in 2006 – you'll eventually be affected by environmental issues. So build them into your thinking when making future financial projections, if only to state, for example, 'these plans are based on the assumption that the weather will be no more extreme than in the past fifty years'.

Pay particular attention to any outside factors that can have a significant effect on sales revenue – demand or price pressures; cost or availability of materials and key services; labour costs, rents, taxes and exchange rates.

Making Regular Revisions

Luca Paccioli, who wrote the world's first accounting book over 500 years ago, claimed that 'frequent accounting makes for long friendships'. No doubt he was hoping to sell more copies of his book (what author isn't?), but he could have said much the same about financial projections. The business world is dynamic, recently to an alarming degree. Frequently revisit your projections to see if they still hold good. Unforeseen and unforeseeable events such as the loss of a major customer or the entry of a new player into the market can throw plans off course. Sure, you may be able to get back on track, but that may mean making more changes in the short term to get to your long-term destination.

Some managers think revising projections to be a sign of weakness. Maynard Keynes, one of the greatest economic gurus of all time and a man who made a fortune out of the stock market over the period of the great depression, summed up the subject neatly: 'When the facts change, I change my mind.'

Revisions are one thing; constant sail trimming is something quite different. The army maxim – order, counter order, disorder – is one that holds good here. Rolling quarterly projections work best, giving the remaining planning period the once-over while adding a new quarter. That way you always have at least one full year's horizon to your projection.

Part VI
Appendixes

'I hate the end of the financial year.'

In this part . . .

We're not finished yet! We couldn't say goodbye without adding in a couple of helpful appendixes filled to the brim with extra information.

The world of accounting is a jargon-filled place, so we've included a glossary in Appendix A that enables you to understand the terms you're most likely to come across and to be clued-up when talking the talk.

Appendix B is another handy list, giving you the lowdown on different accounting software packages so that you can get deep down into the mine of invaluable information lying below the surface of the figures. Also included are some ideas on getting someone else to do that graft for you.

Appendix A

Glossary: Slashing through the Accounting Jargon Jungle

You can keep up with the latest financial jargon on the Free Dictionary Web site at http://financial-dictionary.thefreedictionary.com.

accounting: The methods and procedures for analysing, recording, accumulating and storing financial information about the activities of an entity, and preparing summary reports of these activities internally for managers and externally for those entitled to receive financial reports about the entity.

accounting equation: Assets = Liabilities + Owners' Equity. This basic equation is the foundation for *double-entry accounting* and reflects the balance between a business's assets and the sources of capital that is invested in its assets.

Accounting Standards Board (ASB): The highest authoritative private-sector standard-setting body of the accounting profession in the United Kingdom. The ASB issues pronouncements that establish *generally accepted accounting principles (GAAP).*

accrual-basis accounting: From the profit accounting point of view this refers to recording revenue at the time sales are made (rather than when cash is actually received from customers), and recording expenses to match with sales revenue or in the period benefited (rather than when the costs are paid). From the financial condition point of view this refers to recording several assets, such as receivables from customers, cost of stock (products not yet sold) and cost of long-term assets (fixed assets); and recording several liabilities in addition to debt (borrowed money), such as payables to vendors and payables for unpaid expenses.

accrued expenses payable: One main type of short-term liabilities of a business that arise from the gradual build-up of unpaid expenses, such as holiday pay earned by employees or profit-based bonus plans that aren't paid until the following period. ***Caution:*** The specific titles of this liability vary from business to business; you may see accrued liabilities, accrued expenses or some other similar account name.

accumulated depreciation: The total cumulative amount of depreciation expense that has been recorded since the fixed assets being depreciated were acquired. In the *balance sheet* the amount in this account is deducted from the cost of fixed assets. (Thus it is sometimes referred to as a contra account.) The purpose is to report how much of the total cost has been depreciated over the years. The balance of cost less accumulated depreciation is included in the total assets of a business – which is known as the *book value* of the assets.

acid-test ratio: See *quick ratio.*

activity based costing (ABC): The ABC approach classifies overhead costs into separate categories of support activities that are needed in manufacturing operations and in other areas of the business organisation (such as a sales territory). Cost drivers are developed for each support activity to measure the extent of usage of that support. The annual cost of each support activity is allocated to manufacturing and other areas according to how many cost driver units are used.

Alternative Investment Market (AIM): A stock market in London for shares in small and relatively unproven businesses.

annualised rate of interest and rate of return: The result of taking a rate of interest or a rate of return on investment for a period shorter than one year and converting it into an equivalent rate for the entire year. Suppose you earn 2 per cent interest rate every quarter (three months). Your annualised rate of interest (as if you received interest once a year at the end of the year) equals 8.24 per cent rounded – which is not simply 4 times the 2 per cent quarterly rate. (The annualised rate equals [1+0.02] raised to the fourth power minus one.) See also *compound interest*.

asset turnover ratio: A measure of how effectively assets were used during a period, usually one year. To find the asset turnover ratio, divide annual sales revenue either by total assets or by *net operating assets*, which equals total assets less short-term, non-interest-bearing liabilities.

Association of Chartered Accountants (ACA): The ACA designation is a widely recognised and respected badge of a professional accountant. A person must meet educational and experience requirements and pass a national uniform exam to qualify.

audit report: A one-page statement issued by an accountancy firm, after having examined a company's accounting system, records, and supporting evidence, that gives an opinion whether the company's financial statements and footnotes are presented fairly in conformity with *generally accepted accounting principles*. Annual audits are required by limited companies of publicly owned corporations; many privately held businesses also have audits. The auditor must be independent of the business. An auditor expresses doubts about the financial viability of a business if it is in dire financial straits.

bad debts: The particular expense that arises from a customer's failure to pay the amount owed to the business from a prior credit sale. When the credit sale was recorded, the accounts receivable asset account was increased. When it becomes clear that this debt owed to the business will not be collected, the asset account is written-off and the amount is charged to bad debts expense.

balance sheet: The *financial statement* that summarises the assets, liabilities and owners' equity of a business at an instant moment in time. Prepared at the end of every profit period, and whenever needed, the balance sheet shows a company's overall financial situation and condition.

basic earnings per share (EPS): Equals *net income* for the year (the most recent twelve months reported, called the trailing twelve months) divided by the number of shares of a business corporation that have been issued and are owned by shareholders (called the number of shares outstanding). See also *diluted earnings per share*. Basic EPS and diluted EPS are the most important factors that drive the market value of shares issued by publicly owned corporations.

book value of assets: Refers to the recorded amounts of assets which are reported in a *balance sheet* – usually the term is used to emphasise that the amounts recorded in the accounts of the business may be less than the current replacement costs of some assets, such as fixed assets bought many years ago that have been depreciated.

book value of owners' equity, in total or per share: Refers to the *balance sheet* value of owners' equity, either in total or on a per-share basis for corporations. Book value of owners' equity is not necessarily the price someone would pay for the business as a whole or per share, but it is a useful reference, or starting point for setting market price.

break-even point (sales volume): The annual sales volume (total number of units sold) at which total *contribution margin* equals total annual *fixed expenses* – that is, the exact sales volume at which the business covers its fixed expenses and makes a zero profit, or a zero loss depending on your point of view. Sales in excess of the break-even point contribute to profit, instead of having to go towards covering fixed expenses. The break-even sales volume is a useful point of reference for analysing profit performance and the effects of *operating leverage*.

budgeting: The process of developing and adopting a profit and financial plan with definite goals for the coming period – including forecasting expenses and revenues, assets, liabilities and cash flows based on the plan.

burden rate: An amount per unit that is added to the direct costs of manufacturing a product according to some method for the allocation of the total indirect fixed manufacturing costs for the period, which can be a certain percentage of direct costs or a fixed pound amount per unit of the common denominator on which the indirect costs are allocated across different products. Thus, the indirect costs are a 'burden' on the direct costs.

business angel: Private individuals who invest in entrepreneurial businesses with a view to making a substantial capital gain and perhaps helping with the management.

capital expenditures: Outlays for *fixed assets* – to overhaul or replace old fixed assets, or to expand and modernise the long-lived operating resources of a business. Fixed assets have useful lives from 3 to 39 (or more) years, depending on the nature of the asset and how it's used in the operations of the business. The term 'capital' here implies that substantial amounts of money are being invested that are major commitments for many years.

capital stock: The certificates of ownership issued by a corporation for capital invested in the business by owners; total capital is divided into units, called shares of capital stock. Holders of shares participate in cash dividends paid from profit, vote in board member elections, and receive asset liquidation proceeds; and have several other rights as well. A business corporation must issue at least one class of share called ordinary shares, which in the US are known as *common stock*. It may also issue other classes of stock, such as *preference shares*.

cash flow(s): In the most general and broadest sense this term refers to any kind of cash inflows and outflows during a period – monies coming in, and monies paid out.

cash flow from operating activities: See *cash flow from profit*.

cash flow from profit: In the *cash flow statement* this is called *cash flow from operating activities*, which equals net income for the period, adjusted for changes in certain assets and liabilities, and for depreciation expense. Some people call this *free cash flow* to emphasise that this source of cash is free from the need to borrow money, issue capital stock shares or sell assets. ***Be careful:*** The term free cash flow is also used to denote cash flow from profit minus capital expenditures. (Some writers deduct cash dividends also; usage has not completely settled down.)

cash flow statement: This financial statement of a business summarises its cash inflows and outflows during a period according to a threefold classification: *cash flow from profit* (or, *operating activities*), *investing activities* and *financing activities*.

chart of accounts: The official, designated set of accounts used by a business that constitute its *general ledger*, in which the transactions of the business are recorded.

Companies Acts: A series of UK laws governing the establishment and conduct of incorporated businesses, consolidated into the Companies Act 2006.

compound interest: 'Compound' is a code word for reinvested. Interest income *compounds* when you don't remove it from your investment, but instead leave it in and add it to your investment or savings account. Thus, you have a bigger balance on which to earn interest the following period.

comprehensive income: Includes net income which is reported in the *profit and loss account* plus certain technical gains and losses in assets and liabilities that are recorded but don't necessarily have to be included in the profit and loss account. Most companies report their comprehensive gains and losses (if they have any) in their *statement of changes in owners' equity*.

conservatism: If there is choice as to the amount of certain figures, when preparing accounts the lower figure for assets and the higher for liabilities should be used.

contribution margin: Equals sales revenue minus cost of goods sold expense and minus all *variable expenses* (in other words, contribution margin is profit before *fixed expenses* are deducted). On a per unit basis, contribution margin equals sales price less *product cost* per unit and less variable expenses per unit.

cooking the books: Refers to any one of several fraudulent (deliberately deceitful with intent to mislead) accounting schemes used to overstate profit and to make the financial condition look better than it really is. Cooking the books is different from *profit smoothing* and *window dressing*, which are tolerated – though not encouraged – in financial statement accounting. Cooking the books for income tax is just the reverse: It means overstating, or exaggerating, deductible expenses or understating revenue to minimize taxable income.

corporate venturing: Refers to large companies taking a share of small entrepreneurial ventures in order to have access to a new technology. If this approach works, they often buy out the whole business.

corporation tax: Tax paid by UK companies (with some exceptions) on ‘chargeable profits’. Rates are fixed each year by the government. Reduced rates apply for small businesses.

cost-benefit analysis: Analysis of the costs and benefits of a particular investment or action, conducted to establish if that action is worthwhile from a purely accounting perspective.

cost of capital: For a business, this refers to joint total of the interest paid on debt capital and the minimum net income it should earn to justify the owner’s equity capital. Interest is a contractually set amount of interest; no legally set amount of net income is promised to owners. A business’s *return on assets (ROA)* rate should ideally be higher than its weighted-average cost of capital rate (based on the mix of its debt and equity capital sources).

creative accounting: The use of dubious accounting techniques and deceptions designed to make profit performance or financial condition appear better than things really are. See *profit smoothing* and *cooking the books*.

creditors: One main type of the short-term liabilities of a business, representing the amounts owed to vendors or suppliers for the purchase of various products, supplies, parts and services that were bought on credit; these do not bear interest (unless the business takes too long to pay). In the US, *creditors* or *trade creditors* are usually called accounts payable.

credit crunch: A time when cash is in short supply; businesses find it difficult to raise loans and when they can, interest rates are relatively high.

current assets: Includes cash plus *debtors, stock* and *prepaid expenses* (and marketable securities if the business owns any). These assets are cash or assets that will be converted into cash during one *operating cycle.* Total current assets are divided by total current liabilities to calculate the *current ratio*, which is a test of short-term solvency.

current liabilities: Short-term liabilities, principally *creditors, accrued expenses payable*, corporation tax payable, overdrafts and the portion of long-term debt that falls due within the coming year. This group includes both non-interest bearing and interest-bearing liabilities that must be paid in the short-term, usually defined to be one year. Total current liabilities are divided into total *current assets* to calculate the *current ratio*.

current ratio: A test of a business's short-term solvency (debt-paying capability). Find the current ratio by dividing the total of its *current assets* by its total *current liabilities.*

debits and credits: These two terms are accounting jargon for decreases and increases that are recorded in assets, liabilities, owners' equity, revenue and expenses. When recording a transaction, the total of the debits must equal the total of the credits.

debtors: The short-term assets representing the amounts owed to the business from sales of products and services on credit to its customers. In the US these are known as *accounts receivable*.

deferred income: Income received in advance of being earned and recognised.

depreciation expense: Allocating (or spreading out) a fixed asset's cost over the estimated useful life of the resource. Each year of the asset's life is charged with part of its total cost as the asset gradually wears out and loses its economic value to the business. Either *reducing balance* or *straight-line depreciation* is used; both are acceptable under *generally accepted accounting principles (GAAP).*

diluted earnings per share (EPS): Diluted earnings per share equals net income divided by the sum of the actual number of shares outstanding plus any additional shares that will be issued under terms of share options awarded to managers and for the conversion of senior securities into common stock (if the company has issued convertible debt or *preference* shares). In short, this measure of profit per share is based on a larger number of shares than basic EPS (earnings per share). The larger number causes a dilution in the amount of net income per share. Although hard to prove for certain, market prices of shares are driven by diluted EPS more than basic EPS.

dividend yield: Measures the cash income component of return on investment in shares of a corporation. The dividend yield equals the most recent 12 months of cash dividends paid on a share, divided by the share's current market price. If a share is selling for £100 and over the last 12 months has paid £3 cash dividends, its dividend yield equals 3 per cent.

double-entry accounting: Symbolised in the *accounting equation,* which covers both the assets of a business as well as the sources of money for the assets (which are also claims on the assets).

due diligence: a process of thoroughly checking every aspect of a business's position, including its financial state of affairs, usually as a prelude to a sale or to raising additional funds.

earnings before interest and taxes (EBIT): Sales revenue less cost of goods sold and all operating expenses – but before deducting interest on debt and tax expenses. This measure of profit also is called *operating earnings, operating profit* or something similar; terminology is not uniform.

earnings management: See *profit smoothing*.

earnings per share: See *basic earnings per share* and *diluted earnings per share*.

earn-out: When a business is sold, buyers often make part of their offer conditional on the future profits being as forecasted. This, in effect, makes the seller earn out that portion.

effective interest rate: The rate actually applied to your loan or savings account balance to determine the amount of interest for that period. See also *annualised rate of interest and rate of return*.

equity capital: See *owners' equity.*

external financial statements: The financial statements included in financial reports that are distributed outside a business to its shareholders and debt-holders.

extraordinary gains and losses: These are unusual, non-recurring gains and losses that happen infrequently and that are aside from the normal, ordinary sales and expenses of a business.

Financial Accounting Standards Board (FASB): The highest authoritative private-sector standard-setting body of the accounting profession in the US.

financial leverage: The term is used generally to mean using debt capital on top of equity capital in any type of investment. For a business it means using debt in addition to equity capital to provide the total capital needed to invest in its *net operating assets.* The strategy is to earn a rate of *return on assets (ROA)* higher than the interest rate on borrowed money. A favourable spread between the two rates generates a financial leverage gain to the benefit of *owners' equity*.

financial reports: The periodic financially oriented communications from a business (and other types of organisations) to those entitled to know about the financial performance and position of the entity. Financial reports of businesses include three primary financial statements (*balance sheet*, *profit and loss account* and *statement of cash flows*), as well as footnotes and other information relevant to the owners of the business.

financial statement: The generic term for *balance sheet, cash flow statement and profit and loss account*, all three of which present summary financial information about a business.

financing activities: One of three types of *cash flows* reported in the *cash flow statement*. These are the dealings between a business and its sources of debt and equity capital – such as borrowings and repayments of debt, issuing new shares and buying some of its own shares, and paying dividends.

first-in, first-out (FIFO): One of two widely-used accounting methods by which costs of products when they are sold are charged to cost of goods sold expense. According to the FIFO method, costs of goods are charged in chronological order, so the most recent acquisition costs remain in stock at the end of the period. However, the reverse order also is acceptable, which is called the *last-in, first-out (LIFO)* method.

fixed assets: The shorthand term for the long-life (generally three years or longer) resources used by a business, which includes land, buildings, machinery, equipment, tools and vehicles. The most common account title for these assets you see in a balance sheet is ‘property, plant and equipment’.

fixed expenses (costs): Those expenses or costs that remain unchanged over the short run and do not vary with changes in sales volume or sales revenue – common examples are property rental and rates, salaries of many employees and telephone lease costs.

footnotes: Footnotes are attached to the three primary financial statements to present detailed information that cannot be put directly in the body of the financial statements.

free cash flow: Many people use this term to mean the amount of *cash flow from profit* – although some writers deduct capital expenditures from this number, and others deduct cash dividends as well.

gearing: The relationship between a firm’s *debt capital* and its *equity***.** The higher the proportion of debt, the more highly geared is the business. In the US, the term leverage is usually used here.

general ledger: The complete collection of all the accounts used by a business (or other entity) to record the financial effects of its activities. More or less synonymous with *chart of accounts*.

generally accepted accounting principles (GAAP): The authoritative standards and approved accounting methods that should be used by businesses and private not-for-profit organisations to measure and report their revenue and expenses, and to present their assets, liabilities and owners’ equity, and to report their cash flows in their financial statements.

going-concern assumption: The accounting premise that a business will continue to operate and will not be forced to liquidate its assets.

goodwill: Goodwill has two different meanings, so be careful. The term can refer to the product or brand name recognition and the excellent reputation of a business that provide a strong competitive advantage. Goodwill in this sense means the business has an important but invisible 'asset' that is not reported in its balance sheet. Second, a business may purchase and pay cash for the goodwill that has been built up over the years by another business. Only purchased goodwill is reported as an asset in the balance sheet.

gross margin (profit): Equals sales revenue less cost of goods sold for the period. On a per unit basis, gross margin equals sales price less product cost per unit. Making an adequate gross margin is the starting point for making bottom-line *net income*.

hedge fund: A fund that uses derivatives, short selling and arbitrage techniques, selling assets that one does not own in the expectation of buying them back at a lower price. This gives hedge fund managers a range of ways to generate growth in falling, rising and even in relatively static markets.

hedging: A technique used to manage commercial risk or to minimise a potential loss by using counterbalancing investment strategies.

hostile merger: The term used where a business is acquired against the wishes of the incumbent management.

hurdle rate: The rate of return required before an investment is considered worthwhile.

hyperinflation: A situation where prices increase so quickly that money is virtually useless as a store of value.

imputed cost: A hypothetical cost used as a benchmark for comparison. One example is the imputed cost of equity capital. No expense is recorded for using owners' equity capital during the year. However, in judging net income performance, the company's rate of *return on equity (ROE)* is compared with the rate of earnings that could be accrued on the capital if it were invested elsewhere. This alternative rate of return is an imputed cost. Close in meaning to the economic concept of *opportunity cost*.

income smoothing: See *profit smoothing*.

income statement: American term used for the profit and loss account.

income tax payable: The tax due, but as yet unpaid, on profits earned.

incubator: Usually both a premises and some or all of the services (legal, managerial or technical) needed to launch a business and access seed capital.

initial public offering (IPO): The first offer of a company's shares made to the general public.

insider trading: Buying or selling shares based on information not in the public domain.

internal (accounting) controls: Accounting forms, procedures and precautions that are established primarily to prevent and minimise errors and fraud (beyond what would be required for record keeping).

investing activities: One of three classes of *cash flows* reported in the *cash flow statement*. In large part these are the *capital expenditures* by a business during the year, which are major investments in long-term assets. A business may dispose of some of its fixed assets during the year, and proceeds from these disposals (if any) are reported in this section of the cash flow statement.

junior market: A stock market (such as the AIM) where shares of smaller or younger companies are traded.

last-in, first-out (LIFO): One of two widely used accounting methods by which costs of products when they are sold are charged to cost of goods sold expense. According to the LIFO method, costs of goods are charged in reverse chronological order, one result being that the ending stock cost value consists of the costs of the earliest goods purchased or manufactured. The opposite order is also acceptable, which is called the *first-in, first-out (FIFO)* method. The actual physical flow of products seldom follows a LIFO sequence. The method is justified on the grounds that the cost of goods sold expense should be the cost of replacing the products sold, and the best approximation is the most recent acquisition costs of the products.

leverage: see *financial leverage* and *operating leverage*.

leveraged buyout: A situation where a company is bought by another financed mainly by debt, such as bank borrowings.

LIFO liquidation gain: A unique result of the *last-in, first-out (LIFO)* method, which happens when fewer units are replaced than sold during the period. The decrease in stock requires that the accountant go back into the old cost layers of stock for part of the cost of goods sold expense. Thus, there is a one-time windfall gain in *gross margin*, roughly equal to the difference between the historical cost and the current cost of the stock decrease. A large LIFO liquidation gain should be disclosed in a footnote to the financial statements.

limited liability company (Ltd): Company whose shareholders have limited their liability to the amounts they subscribe to the shares they hold.

listed company: A company whose shares are on the official list of a major stock market, such as the London Stock Exchange.

management accounting: The branch of accounting that prepares internal financial statements and various other reports and analyses to assist managers to do their jobs.

management buy-out: The term used when the management of a business buys out the existing shareholders, usually with the help of a venture capital firm.

margin of safety: Equals the excess of actual sales volume over the company's *break-even point*; often expressed as a percentage. This information is used internally by managers and is not disclosed in external financial reports.

market cap: The total value of a business calculated by multiplying the current market price of its capital stock by the total number of shares issued by the business. This calculated amount is not money that has been invested in the business, and the amount is subject to the whims of the stock market.

net income: American term used to describe profit.

net operating assets: The total amount of assets used in operating a business, less its short-term non-interest-bearing liabilities. A business must raise an equal amount of capital.

net realisable value (NRV): A special accounting test applied to stock that can result in a write-down and charge to expense for the loss in value of products held for sale. The recorded costs of products in stock are compared with their current replacement costs (market price) and with net realisable value if normal sales prices have been reduced. If either value is lower, then recorded cost is written down to this lower value. ***Note:*** Stock is not written up when replacement costs rise after the stock was acquired.

net worth: Balance sheet value of owner's stake in the business. It consists both of the money put in at the start and any profits made since and left in the business.

notes to financial statements: Notes attached to the *balance sheet* and *income statement* which explain: (a) Significant accounting adjustments; (b) Information required by law, if not disclosed in the financial statements.

operating activities: The profit-making activities of a business – that is, the sales and expense transactions of a business. See also *cash flow from operating activities*.

operating assets: The several different assets, or economic resources, used in the profit-making operations of a business. Includes cash, accounts receivable from making sales on credit, stock of products awaiting sale, prepaid expenses and various fixed, or long-life assets.

operating cycle: The repetitive sequence over a period of time of producing or acquiring stock, holding it, selling it on credit and finally collecting the account receivable from the sale. It is a 'cash-to-cash' circle – investing cash in stock, then selling the products on credit, and then collecting the receivable.

operating earnings (profit): See *earnings before interest and income tax (EBIT)*.

operating leverage: Once a business has reached its *break-even point*, a relatively small percentage increase in sales volume generates a much larger percentage increase in profit; this wider swing in profit is the idea of operating leverage. Making sales in excess of its break-even point does not increase total fixed expenses, so all the additional *contribution margin* from the sales goes to profit.

operating liabilities: Short-term liabilities generated spontaneously in the profit-making operations of a business. The most common ones are *payable creditors*, *accrued expenses payable* and *income tax payable* – none of which are interest-bearing unless a late payment penalty is paid, which is in the nature of interest.

opportunity cost: An economic definition of cost referring to income or gain that could have been earned from the best alternative use of money, time or talent foregone by taking a particular course of action.

ordinary shares: Normal shares in business used to apportion ownership.

overhead costs: Sales and administrative expenses, and manufacturing costs that are indirect, which means they cannot be naturally matched or linked with a particular product, revenue source, or organisational unit – one example is the annual property tax on the building in which all the company's activities are carried out.

owners' equity: The ownership capital base of a business. Owners' equity derives from two sources: investment of capital in the business by the owners (for which shares are issued by a company) and profit that has been earned by the business but has not been distributed to its owners (called *retained earnings or reserves* for a company).

partnership: When two or more people agree to carry on a business together intending to share the profits.

preference share: A second class, or type, of share that can be issued by a company in addition to its *ordinary shares.*

Preference shares derive their name from the fact that they have certain preferences over the *ordinary shares* – they are paid cash dividends before any can be distributed to ordinary shareholders, and in the event of liquidating the business, preference shares must be redeemed before any money is returned to the ordinary shareholders. Preference shareholders usually do not have voting rights and may be callable by the company, which means that the business can redeem the shares for a certain price per share.

preferred stock: American term for preference share.

prepaid expenses: Expenses that are paid in advance for future benefits.

price/earnings (P/E) ratio: The current market price of a capital stock divided by its most recent, or 'trailing', twelve months' *diluted earnings per share (EPS)*, or *basic earnings per share* if the business does not report diluted EPS. A low P/E may signal an undervalued share price or a pessimistic forecast by investors.

private equity: Large-scale pooled funds, usually geared up (see *gearing*) with borrowings that buy out quoted companies. This takes those companies off the stock market and makes them private, but the companies are often returned to the market after a few years of financial engineering.

product cost: Equals the purchase cost of goods that are bought and then resold by retailers and wholesalers (distributors).

profit: Equals sales revenue less all expenses for the period.

profit and loss (P&L) statement: The *financial statement* that summarises sales revenue and expenses for a period and reports one or more *profit* lines.

profit ratio: Equals *net income* divided by sales revenue. Measures net income as a percentage of sales revenue.

profit smoothing: Manipulating the timing of when sales revenue and/or expenses are recorded in order to produce a smoother profit trend year to year.

proxy statement: The annual solicitation from a company's top executives and board of directors to its shareholders that requests that they vote a certain way on matters that have to be put to a vote at the annual meeting of shareholders. In larger public companies most shareholders cannot attend the meeting in person, so they delegate a proxy (stand-in person) to vote their shares' yes or no on each proposal on the agenda.

quick ratio: The number calculated by dividing the total of cash, *accounts receivable* and marketable securities (if any) by total *current liabilities.* This ratio measures the capability of a business to pay off its current short-term liabilities with its cash and near-cash assets. Note that stock and prepaid expenses, the other two current assets, are excluded from assets in this ratio. (Also called the acid-test ratio.)

reducing balance: One of two basic methods for allocating the cost of a fixed asset over its useful life and for estimating its useful life. Reducing balance (sometimes called accelerated depreciation) allocates greater amounts of depreciation in early years and lower amounts in later years, and also uses short life estimates. For comparison, see *straight-line depreciation*.

reserves: Another term used for *retained earnings*.

retained earnings: One of two basic sources of owners' equity of a business (the other being capital invested by the owners). Annual profit (*net income*) increases this account, and distributions from profit to owners decrease the account.

return on assets (ROA): Equals *earnings before interest and taxes (EBIT)* divided by the *net operating assets* (or by total assets, for convenience), and is expressed as a percentage.

return on equity (ROE): Equals *net income* divided by the total *book value of owners' equity*, and is expressed as a percentage. ROE is the basic measure of how well a business is doing in providing 'compensation' on the owners' capital investment in the business.

return on investment (ROI): A very broad and general term that refers to the income, profit, gain or earnings on capital investments, expressed as a percentage of the amount invested. The most relevant ROI ratios for a business are *return on assets (ROA)* and *return on equity (ROE).*

road show: Presentations where companies and their advisers pitch to potential investors to 'sell' them on buying into a business.

sales revenue-driven expenses: Expenses that vary in proportion to, or as a fixed percentage of, changes in total sales revenue (total pounds). Examples are sales commissions, credit-card discount expenses, and rent expense and franchise fees based on total sales revenue. (Compare with *sales volume-driven expenses.*)

sales volume-driven expenses: Expenses that vary in proportion to, or as a fixed amount with, changes in sales volume (quantity of products sold). Examples include delivery costs, packaging costs and other costs that depend mainly on the number of products sold or the number of customers served. (Compare with *sales revenue-driven expenses*.)

Securities and Exchange Commission (SEC): The US federal agency established by the federal Securities Exchange Act of 1934, which has broad jurisdiction and powers over the public issuance and trading of securities (stocks and bonds) by business corporations. In the UK, the London Stock Exchange and the Department of Trade and Industry cover some of the same ground.

seed capital: The initial capital required to start a business and prove that the concept is viable.

sole trader: Simplest type of business. No shareholders, just the owner's money and borrowings. Also known as a sole proprietor.

statement of cash flows: See *cash flow statement*.

statement of changes in owners' (shareholders') equity: More in the nature of a supplementary schedule than a fully fledged financial statement – but, anyway, its purpose is to summarise the changes in the owners' equity accounts during the year.

stock: Goods on hand for resale, or held in raw materials, or as work in process. In the US, the term inventory is more commonly used. Stock, in the US, is usually used to describe share capital.

straight-line depreciation: Spreading the cost of a fixed asset in equal amounts of depreciation expense to each year of its useful life. Depreciation is the same amount every year by this method.

true and fair: The auditors' confirmation that the balance sheet and income statement show a 'true and fair' view of the business, in accordance with generally accepted accounting principles.

variable expenses (costs): Any expense or cost that is sensitive to changes in sales volume or sales revenue.

venture capital: Professionally managed funds that buy stakes, usually in private companies, to help them realise their growth potential.

warranties: A guarantee given by the officers of a company to a buyer of that company that all the material facts have been disclosed. Serious financial penalties await if this is found not to be the case.

window dressing: Accounting devices that make the short-term liquidity and solvency of a business look better than it really is.

working capital: The difference between current assets and current liabilities.

zero based budgeting: Where every expense has to be justified in full for an upcoming period as opposed to just accounting for any higher rate of expenditure.

Z-Score: An algorithm that uses various financial ratios to arrive at a figure below which firms have a high chance of failure.

Appendix B

Accounting Software and Other Ways to Get the Books in Good Order

This chapter gives you some general pointers for narrowing down your choices when deciding which way to keep your books up to date. The route you choose has to be right for you and right for your business:

- Get the person responsible for keeping your books involved in the selection process early on.
- Make a list of the features that you need.
- Get a recommendation from your business friends and associates who are already using an accounting program, bookkeeper or accountant.
- Think about how simple or difficult the program or process is to set up.

Popular Accounting Programs

With the cost of a basic computerised bookkeeping and accounting system starting at barely £50, and a reasonable package costing between £200 and £500, it makes good sense to plan to use such a system from the outset. Key advantages include speedy preparation of VAT returns and having no more arithmetical errors; preparing your accounts at the year-end can be a whole lot simpler.

Sourcing accounting and bookkeeping software

You can find dozens of perfectly satisfactory basic accounting and bookkeeping software packages on the market. Some of the leading providers are:

- **Banana Accounting for European Companies,** www.banana.ch/cms/en**:** A double-entry accounting program for European small businesses, associations and financial companies, which costs €79. Banana is a Czech firm.
- **Business Management System for Book Publishers,** www.acumenbook.com**:** Business management software, including royalty accounting and job costing, designed specifically for book publishers.
- **C. A. T.,** www.catsoftware.com**:** Software packages addressing the specific accounting tasks that are unique to the outdoor amusement and carnival business.
- **CheckMark Software Inc,** www.checkmark.com**:** Payroll and accounting software.
- **Creative Solutions,** www.creativesolutions.com**:** Integrated tax, accounting and practice management software designed exclusively for practising accountants.
- **DBA Software,** www.dbasoftware.com**:** A small business software package focused exclusively on the needs of small manufacturers and jobbing shops.
- **Dosh,** www.mamut.com/uk/dosh**:** Part of Mamut, a leading European provider of complete, integrated software solutions and Internet services for SMEs. You can

download trial versions of the software from the website. Prices start at £49.50.

- **QuickUSE Accounting,** www.quickuse.com: Integrated accounting software with free downloads from the site.
- **Sage,** http://shop.sage.co.uk/accountssoftware.aspx: The market leader in accounting software with packages from £120, plus VAT.
- **Red Wing,** www.redwingsoftware.com: Mid-range software systems designed for small to mid-size businesses, agribusinesses and nonprofits.
- **R. T. I.,** www.internetRTI.com: Accounting and operational software for restaurants.

TIP

If you want some help in choosing a system, visit Accounting Software Reviews (www.accounting-software-review.toptenreviews.com), which ranks the top ten accounting packages priced from around $40 up to $2,000. Over 100 criteria are used in their test, which they carry out yearly. At the time of writing, Sage's Peach Tree Complete package, priced at $299.99, is rated as the best of the bunch, which just goes to show that money isn't everything when it comes to counting it!

Using a Bookkeeping Service

Professional associations such as the International Association of Bookkeepers (IAB) (www.iab.org.uk) and the Institute of Certified Bookkeepers (www.book-keepers.org) offer free matching services to help small businesses find a bookkeeper to suit their particular needs. Expect to pay upwards of £20 ($30/€23.50) an hour for services that can be as basic as simply recording the transactions in your books, through to producing accounts, preparing the VAT return or doing the payroll. The big plus here is that these guys and gals have their own software.

Hiring an Accountant

If you plan to trade as a partnership or limited company or look as though you'll grow fast from the outset, you may be ready to hire an accountant to look after your books. Personal recommendation from someone in your business network is the best starting point to finding an accountant. Meet the person, and if you think you could work with him or her, take up references as you would with anyone you employ, and make sure he or she is a qualified member of one of the professional bodies. Take a look at the Association of Chartered Certified Accountants (www.accaglobal.com) and the Institute of Chartered Accountants (www.icaewfirms.co.uk).

To access the cheat sheet specifically for this book, go to www.dummies.com/cheatsheet/understandingbusinessaccountinguk.