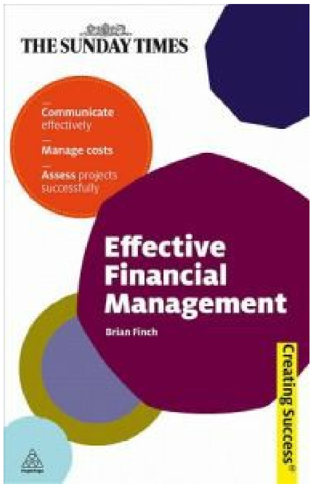

Book Effective Financial Management

Brian Finch
Kogan Page, 2010

Recommendation

In business, the numbers are everything. Finances constitute a company's ultimate bottom line, and if you mismanage your accounts, sooner or later your firm will break down. Business expert Brian Finch shows you how to take charge of your organization's money in this comprehensive guide. However, the book bases its information on UK law and practice, so non-UK readers will need to make adjustments for some of Finch's comments and phrasing. Nonetheless, *BooksInShort* suggests that first-time business owners of any nationality looking for a basic primer on how company financials work will benefit from reading it. After all, George Bernard Shaw once said that England and the United States are "two nations separated by a common language." Clearly so, but when it comes to money, everybody counts the same way.

Take-Aways

- Financial management involves far more than just bookkeeping.
- Raising capital, budgeting, evaluating projects, buying supplies, creating financial statements and communicating results all are part of good fiscal organization.
- Your budget is the financial expression of your business plan.
- Forecast sales and their costs as a start to your budgeting.
- Keep your projections realistic, and have an objective outsider review them.
- Cold-bloodedly assess which new ventures and projects will bring the greatest returns to your business.
- Keep your company's cash position strong; act assertively to collect debts owed your firm.
- Controlling costs should "be part of the DNA" of your organization.
- Guarantee the availability of your inputs by setting up accounts with alternative suppliers.
- In tough times, renegotiate your property lease; extend the term in exchange for reduced rent.

Summary

Financial Management Requires Solid Business Planning

Financial management concerns much more than just your firm's bookkeeping. It also involves raising capital, budgeting, estimating and managing costs and cash, evaluating projects, purchasing supplies, creating financial statements and – just as importantly – communicating to your stakeholders about your company's financial position.

> "Financial management is crucial at all stages in the business cycle and whatever the state of the business."

When it comes to financial operations, everything starts with a business plan, which should consider and answer these questions, among others: Are your products and services right for your marketplace? Do your sales operations make sense? Do you have an effective Internet strategy? After your executive team members add their ideas to the plan, seek input from your investors or partners. Use your business plan in discussions with your banks. Include your sales figures for the past three years, as well as your current year estimates.

> "The numbers matter, of course...but get the order right: The ideas come first and lead to the numbers."

Make your business plan transparent, and never fudge your figures, even if they don't present the most favorable picture: No business can overcome a reputation for dishonesty. Spell out a sustainable strategy that your competitors can't easily copy, and plot the most appropriate risk scenarios. Use these measures to develop and manage your business plan:

- **"Gross margin"** – This ratio (your total revenue, net of cost of sales and taxes, divided by total revenue) helps you see if you're charging correctly and if your costs are too high.
- **"Debtor days"** – To determine how quickly your customers pay you on average, divide the amount clients owe your firm by your net yearly sales and multiply by 365. Calculated over different points in time, debtor days can alert you to slowing receipts.
- **"Creditor days"** – How long does it take you to pay your suppliers? Divide what you owe "trade creditors" by your yearly cost of sales, and multiply that by 365. If you're slow to pay your bills, you may have a liquidity problem.
- **"Stock turn"** – Figure out how fast your inventory is moving by dividing the "value of stocks at cost" by your yearly cost of sales, multiplied by 365.
- **"Gearing"** – To track your debt, or leverage, calculate "net debt (that is debt less cash in hand)," and divide that by the sum of debt and any shareholders' equity. The higher your leverage, the more risk in your business.

> "Cash is king, and being able to offer cash for products and services may win you a better price."

While the numbers are important, remember that they only represent the results of your creativity, ideas and execution.

Projects

Dynamic businesses depend on new projects and ventures to move forward, but no firm should proceed blindly with any new plan. Systematically assess whether any proposed project will deliver the returns you need. Keep emotion out of your planning; don't fool yourself into thinking that a pet project will fare better than an objective analysis indicates.

> "The business plan is your tool for managing your business in good times and in bad."

A good project evaluation involves calculating the project's "discounted cash flow." After all, you want to know that the project will earn you more than the interest on that expenditure would have if it were simply invested. A positive "net present value" – derived from the sum of all the "future forecast cash flows, discounted back to today's value" – means the project will be a profitable investment. Additional ways to assess a project's value include the "payback" method, which calibrates when you'll recoup your investment, and the "accounting rate of return," in which you divide the potential net profit derived from the project by what you'll spend on it. Examine all projects after their completion to see how they fared and adjust your future planning.

Budgets

A budget is simply a forward-looking business plan expressed in numbers. Think of the budget as a "navigation chart for a ship": The budget and the beliefs underlying it show where the business is headed and allow managers to enact mid-course corrections, if necessary. In drawing up an annual budget, include realistic assumptions about your firm's prospects; for example, estimate a "5% increase in sales, 3% increase in business property taxes," and so on. Clarify your suppositions and ensure that your team agrees with them; after all, your budget is "a joint enterprise" among your executives.

> "Cost-cutting is seldom the answer to fundamental problems, but good cost control will buy time to get things right."

Forecasting sales is the first step in setting up your budget. Make your estimates based on past months' trends, and adjust them for any uptick in revenues you can predict. Reflect those increases in your forecasted costs of sales. Produce a cash budget, which accounts for money in and out of your business, as well as a balance sheet and a profit and loss statement (P&L); the latter records sales, while cash-flow reports show when customers actually pay you. Cash flow includes capital expenditures, but not depreciation, which goes on the P&L as a noncash expense. Your "budget commentary" verifies all information as accurate and provides useful context for your assumptions and results.

> "A recession is a good time to ask for better prices from your existing suppliers and to check what other suppliers may offer."

If you predict deficits, cut your spending or secure additional funds from your bank or shareholders. Include an independent evaluator in the essential budget review process. The budget review is not just a math check; it analyzes all budget choices and presumptions. Make sure that your gross margins are realistic. Keep a little "hidden fat" in the budget for flexibility if necessary, but keep your budget as realistic as possible. Overly optimistic profit estimates may look nice on paper but they interfere with realistic decision making.

Cash and Costs

Keep close track of how much cash you have; manage and forecast it daily to ensure you have enough money with which to operate. Your cash position benefits from each sale you make and each debt you recover, so be selective about your customers. Slow- and nonpaying clients will blow a hole in your liquidity position. Constantly monitor your payment collections; your accounting system should prompt you to send out regular reminders to overdue accounts. Act assertively to collect debts owed you: Hire a debt recovery firm, and consider legal proceedings if necessary. If cash gets tight, consider liquidating assets such as property and inventory.

> "The higher the level of debt that a business has, the higher its financial risk."

All businesses should keep costs under control to maximize their profitability. If your firm runs into problems, you have three cost-cutting options: "a quick fix, continuous cost control and reengineering the business." Management buyouts fall into the quick-fix category. A management team is motivated to reduce expenses quickly in order to satisfy investors, so short-term profits get a boost, but long-term viability can suffer. Why? Many of the overhead costs executives first slash turn out to be essential to the firm's proper functioning, so these expenses end up creeping back into the company's operations.

> "For most businesses staff really matter. Whilst the old saying goes that nobody is irreplaceable, your staff are the business."

Continuous cost controls should "be part of the DNA of a business." Regularly evaluate expenses such as utilities and transportation to get the most for your money. Make sure your business operations all deliver true value. Hire wisely and only when needed. Good cost controls can "buy you time," but reorganizing your business, also known as "business process reengineering," can overhaul your cost structure. Go back to square one in conceptual terms: What would be the most efficient way to set up your company if you were starting over? Comb your business functions to find opportunities to streamline and improve operations. Focus on the bigger picture first: Look at your distribution, financing and insurance costs. Consider your staffing and whether reducing your business hours or outsourcing might improve your bottom line. Once you have a clear picture, make the necessary changes.

Supply

Consider the two most important factors in your sourcing: costs and the "security of supply." Your company would be in big trouble if suddenly it could not get the supplies and services it needs. Guarantee the availability of your inputs, especially if something goes wrong, by establishing accounts with alternative wholesalers in case your main supplier suddenly shuts down. If your primary computer vendor closes its doors, maintain alternative contingency plans. Ask your resources for their most favorable "terms of trade," that is, the best prices, the most generous financing and the longest payment periods they can offer you. These credit policies are usually flexible, but you may need to do some work to uncover the top deals.

Property and Assets

Most business owners assume that property costs are set in stone in explicit lease contracts. Yet you may have some leeway in negotiating your property costs. If times are tough, you may be able to get better rental terms on your space, particularly if rents are down and vacancies are on the rise in your area. Under such conditions, ask your landlord for a rent reduction in exchange for extending the length of your lease term. In the UK, remit your business taxes when they're due, since failure to pay periodic assessments may prompt your local authority to demand immediate payment of your entire annual tax. UK local authorities often deal with nonpayers by dispatching "bailiffs to seize goods to the value" of the outstanding tax debt.

> "When trading is tough, the old adage about banks comes true: 'They lend you an umbrella when it's dry and want it back when it rains'."

When purchasing capital goods for your business, strive for the lowest prices. Ask for better terms, and be ready to negotiate. In preparation, keep firm objectives in mind prior to any discussion, and shoot for a win-win arrangement. Be ready to trade some aspect of the deal you don't care about for something that is important to you. To save money, judge whether your company truly needs that absolutely top-quality piece of equipment; perhaps something that costs less will perform sufficiently well. Investigate used gear, and look into bankruptcy sales for good deals. See if your trade group maintains "buying cooperatives" that can offer members discounts on supplies and equipment purchased in bulk.

Banks and Financing

Most banks include a clause in their loan agreements that permits them to demand repayment of any loan within 30 days. Usually invoked only during a credit crunch, these demands can wreak havoc with your financing plans. How should you respond? Banks hate notoriety, so your best move may be to publicize the institution's demand. But it's better to forestall such an event by maintaining a solid relationship with your banker. Keep your local bank manager informed about your firm's financial health. Let him or her know in advance if you will be late making a repayment; this can earn you special consideration when you need it most. Banks also often ask company directors to make "personal guarantees" as security for commercial loans. If your bank insists on this term, negotiate the best deal you can. Alternative sources of financing include venture capital, leasing, family loans and "business angels," investors looking for a good return from your business.

Accounts and Company Structure

Your financial statements communicate your firm's health to a wide variety of audiences, all of whom have some interest in how well your business is doing: regulators, taxing authorities, shareholders, partners, banks, suppliers and even clients. Certainly, someone who is considering buying your business will want to examine your books. And you may need to have your statements audited by reputable accountants, depending on the size of your company and local, state and federal regulations. Your bankers, investors and potential acquirers likely will insist on audited accounts.

> "Some asset deals are readily available from familiar suppliers – you just need to ask – some need seeking out."

How you organize your company will depend on national and local regulations, and on tax considerations. Choose the structure that works best for your particular situation at the moment: "sole trader, limited company" or "limited partnership." And remember that changing laws and tax schemes may lead you to alter how your firm is registered.

> "During downturns it is not surprising if markets, processes and innovation actually evolve at a faster not a slower rate. It is a time to seek new ideas with even more vigor."

Always take advantage of "free resources." For example, trade associations often provide discounts for informative conferences. If you export, find out if your government offers subsidies for participation in overseas sales events. Use government grants available to develop underutilized areas. Get tax rebates if you operate in a depressed region, and avail yourself of free advice and counseling offered by public authorities.

About the Author

Brian Finch, co-founded a retail bookselling business and developed its internet arm, acting subsequently as its finance director.