LEARNING MADE EASY

Australian Edition

Planning a Profitable Business

for dummies
A Wiley Brand

Build a business with profit in mind

Use smart pricing to improve your bottom line

Identify your competitive edge

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Author of *Small Business for Dummies, Bookeeping For Dummies* and *MYOB® Software For Dummies*

Planning a Profitable Business

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Introduction

I confess to feeling a little ambivalent about the title of this book. While 'Planning' and 'Profitable' offer a delightful opportunity for alliteration, to go into business with only profits in mind is the antithesis of my usual approach. To my mind, successful business is at its best when it reflects the values and interests of the owner, and when the owner's enthusiasm for what they do shines bright.

However, the reason I chose to write *Planning a Profitable Business For Dummies* is this: I've met many business owners who love what they do — indeed, they're hard-pressed to think of anything else they might want to do with their life — but find business profits remain elusive, year in, year out.

In this book, I share the insights I've gained over 30 years of working with small business. I highlight the importance of smart strategy and detailed competitor analysis, and take you step by step through the basics of planning for profitability, including finding your competitive edge, pricing, budgeting and financial modelling.

I do hope you can use this guide as a reference to yield more profits — and more pleasure — from the business that is your passion. (How's that for some alliteration?)

About This Book

Despite the branding, I don't think you're a 'dummy' — far from it. For me, *For Dummies* books are about a 'can-do' attitude. No matter how inexperienced you are, if you're ready to give something a go, this book is here to help.

This book (all 11 bite-sized chunks of it) is designed so you can pick it up at any point and just start reading. Perhaps you want to know about profit projections (Chapter 7) but you're not the least interested in competitor analysis (Chapter 2). That's fine — just skip the first six chapters and start off from where you want to be.

One more thing. Throughout this book you'll see *sidebars* — text that sits in a separate box with grey shading. Think of sidebars in the same way as you might do about designer brands: Nice to have, but not essential. Feel free to skip these bits.

Foolish Assumptions

When you work with small business, you learn to assume nothing. I see everything from clients who time all strategic decisions to fit with the stars (no kidding!), to multimillion-dollar enterprises that have grown out of nothing in a matter of months.

So, in this book I try to assume very little about you. You don't need to know anything about business planning, financial projections or marketing, and I try to explain all concepts in the simplest possible way.

Icons Used in This Book

AHEAD OF THE PACK

Want to be streets ahead of the competition? Look for this handy icon.

MONEY STUFF

Get out your calculator and start doing those sums. This icon flags money stuff, highlighting vital information for anyone with an eye for making a dollar or two.

REMEMBER

Tie a knot in your hankie, pin an eggtimer to your shirt but, whatever you do, don't forget . . .

TIP

This icon indicates handy advice or insights into how to improve your business or make life easier.

TRUE STORY

If you can't learn from history, you're doomed to repeat your mistakes. Real-life stories from businesses and people who've been there provide all the history lessons you could ever want.

WARNING

A pitfall for the unwary. Read these warnings carefully (and then you can't say no-one told you . . .).

Where to Go from Here

Planning a Profitable Business For Dummies is no classic work of literature (one day, I promise myself!), and so you don't need to start reading from page one and plough through to the end. Instead, jump in and start reading from whatever section is most relevant to you:

- In Chapters 1, 2 and 3, I focus on expectations, finding your competitive edge and analysing the business environment in which you operate. Although not particularly financial in nature, these elements of business strategy are key to profitability.
- Chapters 4, 5 and 6 talk about the building blocks of profitability: Ensuring you have sufficient working capital, setting your prices to maximise profits, and creating ambitious, yet realistic, sales targets.
- Chapters 7, 8 and 9 go to the heart of financial management, and cover the challenging topics of profitability projections, calculating profit margins and understanding financial statements. Even if you're not a numbers person, and you have an overwhelming instinct to avoid these three chapters, I encourage you to persist.
- Chapter 10 offers ten fabulous tips for squeezing that extra bit of profit from your business. Chapter 11 follows hot on its heels, providing smart tips about selling your business and reaping the rewards.

Thank you for taking the time to read *Planning a Profitable Business For Dummies*. I hope you find something along the way that helps you and your business flourish.

IN THIS CHAPTER

- » Finding your inner entrepreneur
- » Discovering the secrets for profit
- » Balancing dreams with just a pinch of reality
- » Taking the time to time it right
- » Developing a financial plan

Chapter 1
Building a Business with Profit in Mind

When I talk to people about their business and hopes for the future, I'm aware that I'm in a unique position. Listening to anybody's dreams is a privilege, but even more so when people share their doubts and hopes about this significant part of their lives.

People often ask me for help modelling the financials to support their business idea. They feel that it's the financial plan, and this plan alone, which will reveal the secret of how to make a profit.

Financial plans are crucial to profitability, that's for sure. However, just as important is establishing what you're going to do differently in your business, how you're going to take advantage of this difference, and whether this difference will be something that customers really want.

In this chapter, I touch on all these aspects, as well as the importance of knowing how to temper ambition with realism to keep your expectations grounded, and how to manage the level of risk that any new venture entails.

Shifting to an Entrepreneur Mindset

For almost all businesses, in order to build something that's truly profitable, you need to create a business where employees — rather than yourself — are the ones doing most of the work.

If you look around you, most medium-sized businesses fall into this category. For example:

- My local plumbing company has a team of plumbers, each with their own van and apprentice. The owner occasionally helps with tricky jobs, but mostly focuses on management and marketing.
- The place where my son used to learn piano is a music school, with lots of different tutors teaching different instruments. The owners teach sometimes, but rely on a team of teachers to deliver most of the lessons.
- A girlfriend of mine has a business selling baby sleeping bags. She no longer stitches each sleeping bag herself. Instead, she still manages the design, marketing and distribution, but has shifted production offshore.
- My neighbour runs a small chain of three cafes. He rarely cooks or serves tables any more, but focuses on the finances and management.

Can you see that for each of these examples, the owners have made a leap in how they think of their businesses? The plumber is now the manager of a plumbing services company; the music tutors started their own music school; the barista opened a chain of cafes; the seamstress runs a manufacturing company. In all of these examples, the owners no longer unblock pipes, teach violin, serve coffees or stitch fabric. In return, the potential for each of these businesses is that the owners can have more freedom and earn more money than they otherwise would have done.

For me, this transition from owner to entrepreneur is really exciting. Such freedom provides an opportunity to do other things in life that have only been dreams up until now.

If you haven't made this transition, and your business is still dependent on you for pretty much every cent of income, my question to you is this: Have you ever consciously made the decision not to be entrepreneurial? Or have you never really let yourself imagine how you could do things differently?

If your answer is 'yes' to the latter, do try to give the visionary in you some room to breathe. Spend time thinking about how you can grow your business and create something that has a life of its own. Chapters 2 and 3 may help develop your thinking in this way.

Finding the Secret to Profit

Businesses fall into three broad categories:

- The first type of business is one that has been done before, and therefore has been tried and tested. I call this a *traditional business.*
- The second type of business is one that finds its own niche, thereby doing something especially tailored to a small group of customers. I call this a *niche business*.
- The third type of business is one that launches an entirely new concept on the world. I call this an *entrepreneur business*.

Each category of business has its own secret to profitability, which I explain in the next sections of this chapter.

Expressing your difference in a traditional business

The most common kind of business (and probably the safest and most reliable) is a *traditional business*. Most retailers and many service businesses fall into this category — for example, bookshops, builders, electricians, florists, hairdressers or software engineers.

While traditional businesses were a safe bet in times gone by, changing technology means that many of these business models are now relatively precarious. For example, bookshops used to offer solid profits, so long as you selected a good location and knew your trade. However, the changes brought about by ebooks and online distribution mean that, nowadays, running a bookshop is a very different proposition indeed. Similarly, a bookkeeping business may have been a steady income stream in the past, but cloud technology and new accounting software solutions are rendering many traditional bookkeeping services obsolete.

AHEAD OF THE PACK

In my experience, the secret to profitability with a traditional kind of business depends on your ongoing capacity to differentiate yourself from your competitors. If possible, this difference should capitalise on your skills and resources, so that this difference is hard for competitors to imitate.

Here are some examples of businesses working in this way:

- A regional bookshop acts not just as a retail store, but doubles as a quasi-community centre, with morning teas, book clubs and regular author readings.
- A guitar teacher livestreams a performance of his original music each month, selling charts for these compositions, promoting his online lessons and attracting regular donations via Patreon.
- A vet provides a 24-hour mobile service to people's homes.
- A cabinet maker mills his own wood on his 30-acre property on the South Coast of NSW, using this timber for his custom-built high-end furniture.
- In addition to regular services, a mechanic offers monthly do-it-yourself classes where she teaches customers how to do basic maintenance on their own vehicles.

I talk much more about differentiating yourself from your competitors, and identifying your strategic advantage, in Chapter 2.

Marketing to a niche

A *niche* business creates something specialised and caters to a narrow but (hopefully) dedicated market. A niche business can cover anything from manufacturing custom guitars to producing hand-stitched silk lingerie, or from designing permaculture gardens to cooking special food for diabetics.

The best thing about niche businesses is that they can operate on a small scale. Running a micro business typically means lower risk, less expense setting up and an opportunity to try out new ideas and test the response.

TIP

I've worked with many owners of niche businesses and, in my experience, the secret to profitability lies in the strength of your marketing skills and strategies.

One of the huge changes in business in the last couple of decades is the way that advertising is becoming increasingly specific. Just 20 years ago, people were stuck with newspaper advertising, hoping that out of the 80,000 people reading the paper, maybe three people would be interested. Now, you can create marketing campaigns on social media that define who will see your ad based on their age, where they live, what their interests are, and much more. You may only reach 800 people with your advertising, but if your message is specific enough, chances are you'll still get at least three responses.

With these highly specific marketing tools in mind, the secret with niche businesses is to identify your niche and tailor your messages specifically to that niche. Don't be shy about narrowing your market, and then narrowing it again and again, until you reach the exact demographic with the perfect fit for your product or services.

For more about developing competitive strategy, check out Chapter 2.

Capitalising on invention

The last type of business is called the *entrepreneur* type, reserved for new inventions or new market concepts. Untested and unknown, this type of business can occasionally experience resounding success or spectacular failure. (I still feel a pang whenever I remember my friend's invention of a solar-powered windmill-hat, a great idea but scarcely a hot fashion item.)

With the entrepreneur type of business, you're taking a gamble. Though the chance of failure is high, if you do succeed, the rewards can be huge.

AHEAD OF THE PACK

In my experience, the secret to entrepreneur kinds of businesses relies on two things. First, you need excellent market research. Second, you need enough start-up capital. While I don't have enough scope within this book to explore the topic of market research for a new business, I do focus on start-up and working capital in Chapter 4.

Keeping Expectations Real

As the years have passed by, I've developed a sniffer-dog instinct for which businesses are likely to succeed, which are going to struggle and which are doomed to fail. Although I usually wish I wasn't so chillingly accurate (especially when I predict failure), occasionally life delivers a surprise — the success of an overpriced French restaurant with a mad chef, for example, or the survival of a bed and breakfast in the back of beyond.

REMEMBER

Running a business is an inherently risky game. Sometimes, this risk makes things exciting and, other times, just plain old scary. Of course, business success is a fantastic feeling but, on the other hand, failure can be quite catastrophic. You can lose your house, your job, even your family, all in the one hit, not to mention the disillusionment of having precious dreams crushed by harsh reality.

Assessing your chances of survival

Australians are a pretty entrepreneurial bunch. With a population of 25 million (give or take a few), almost 2.4 million businesses are alive and kicking. Impressive, don't you reckon? Almost 10 per cent of the population run their own business.

But what about business survival? Are all these businesses fly-by-nighters, starting up one year and disappearing the next? Not so long ago, a business coaching franchise advised a client of mine that 80 per cent of businesses go bust in the first year, and only 8 per cent of businesses survive five years or more.

Pish tosh. Business is tough, but it's not a suicidal mission. The ABS reports that half of new businesses without employees, and 30 to 40 per cent of new businesses with employees, cease trading within the first three years. However, these figures don't shed light on how many businesses chose to cease trading (as opposed to going broke or 'failing'), and how many businesses actually experienced financial loss upon closing their business. In my experience, very few business people rate their overall experience as a negative one.

Staying motivated

Unfortunately (or maybe fortunately), the brilliant business ideas that earn $10 million in the first year are few and far between. For many people, the only sure-fire way to succeed is to work loooong hours not just in the first year or so, but often for many years beyond that. Many people find themselves taking on the roles of bookkeeper, marketing consultant, salesperson and managing director all in one.

WARNING

One of the hardest things about being self-employed is staying motivated. Not just in the first year, where everything is interesting and different, but also year after year after year. Of course, as your business grows, and if you're seeking above average profits, your likely aim is that you employ staff to help. Ideally, you can arrive at a point where your business earns money, even if you're not working in it every day of the week.

Weathering feast and famine

Sometimes, the highs and lows of small business profits make even Melbourne's weather look reliable. A bumper year, and the bank account is rosy. Then you lose a client or two, interest rates go up and, before you know it, you're wondering how to pay the rent.

MONEY STUFF

In Chapter 4, I talk about creating budgets for business set-up expenses, and share tips for securing business finance. Some consultants advise you not to expect to make any money at all in your first year of business, and to have savings put aside to pay for your living expenses during this time. Such advice is prudent, but the truth is that sometimes businesses take even longer than a year before they make a profit, and even businesses that have been cruising along happily for years can strike hard times.

I used to find the feast and famine of running my own business very stressful, but I'm getting better at managing this dichotomy as time goes by, even managing to put money aside when things go well. How you cope with the effect of this insecurity depends not only on your personality, but on your family commitments as well.

Understanding how risk relates to gain

In Chapter 2, when I talk about identifying the strategic advantage for your business, I explain that key to strategic advantage is doing something different from your competitors and, ideally, ensuring this difference is hard for others to copy. The stronger this strategic advantage is, the more potential for profit.

Logically, if you're doing something different that nobody else is doing, chances are your idea is either untested or requires significant capital (or both). For this reason, the ideas that offer the most potential for gain are usually also the ones that carry the most significant risks.

For example, if I decide to start a business as an electrician in my local area, chances are that once established, I can generate similar profits to other electricians in town with minimal risk. However, imagine I decide to start a business specialising in high-end solar battery systems and storage. While the potential profits are higher, the risk is higher too, both in terms of capital investment required and the risk that demand may not be sufficient for my services.

REMEMBER

If your business is very similar to many others, you may find it's tricky to identify strategic advantages and to stand out from your competitors. The upside of a business that's very similar to many others is that the risks are usually lower; the downside of a low-risk business is that it's always going to be tricky to charge premium rates or make above-average profits.

Getting the Timing Right

One of the secrets of creating a profitable small business is getting the timing right: The right timing for the business idea, the right timing for you and your family and the right timing for the business environment.

Picking fads, fashions and trends

An experienced entrepreneur once said to me, 'If real estate is all about position, position, position, then business is all about timing, timing, timing.' He's right, of course. If you were selling fondue sets in the 1970s, chances are your business would be successful. Try to sell the same fondue sets for a living these days, and it would be slim pickings indeed (although my mother does have very fond memories of cheese and chocolate fondue dinner parties).

To capitalise on business trends and maximise your chances of profit, bear the following in mind:

TIP

TRUE STORY

- **Fickle fashions:** Humans are capricious creatures and what's hot today may be ice-cold tomorrow. Whether the latest craze is kids going nuts about a Disney action doll or making organic hand sanitiser, make sure you're not the one who suffers when everyone gets bored and tired. Try to jump on the bandwagon near the beginning or during the build-up — don't leap in at the peak.
- **Industry trends:** The difference between a trend and a craze may seem hard to pick at first, but the difference is both real and important. Be aware of trends in your industry and capitalise on opportunities. For example, the long-term and growing interest in low-carbon and energy-efficient building supplies is a positive trend that indicates many business opportunities.
- **Lead times:** If you've got a long lead time for your project, research the project well. I remember a client who decided to build storage units in a busy country town. The demand seemed guaranteed, because there weren't any at that time. Three years later (after prolonged development applications through council and a $500,000 construction), the units were ready. The only snag was two other developers opened units that same year, creating a glut of supply and fierce price wars.
- **Bleeding edge or cutting edge?** You may love being leader of the pack, but creating a product or service that customers aren't ready for yet is pointless.
- **Seasonal variations:** If you're planning a business that is highly seasonal, factor this aspect carefully into your timing when making your business plan. Give yourself time to plan carefully for the peak season so you can take full advantage of that period.

WARNING

My last comment about timing is that Australia's business environment is shifting faster than ever, and what might seem to be perfect timing right now could end up being horrendous timing in hindsight.

In Chapter 3, I help you evaluate how robust your business idea might be in the face of natural disasters, pandemics, recessions or changes in government policy, and how you can design your new business to be as agile and responsive as possible. A business that responds quickly to change will be much better positioned to thrive than one that isn't.

Making sure you're ready

Of course, building a profitable business isn't just a question of whether the outside world is ready for what you have to offer. Business success is also about how ready you are, personally. If you're starting a business from scratch, consider the following:

- **Your ability to understand budgets and financial projections:** If you're looking to build a business with profit specifically in mind, then understanding pricing, margins, financial projections and financial statements is essential. (So much so, I devote all of Chapters 5 through to 9 to these very topics.)
- **Your age, health and stamina:** Age can be a factor at both ends of the spectrum. Most 18 year olds are unlikely to have enough experience to cope with running their own business. On the other hand, a 65 year old may be short on motivation, ambition and energy, especially for new ventures requiring long hours and huge input.

MONEY STUFF

- **Your access to capital:** Do you have enough capital to get your business started? Undercapitalised businesses risk missing out on opportunities and lack capacity for growth. (I talk lots more about how much money is enough in Chapter 4.)
- **Your family life:** Don't start a new venture without consulting your family and enlisting their support. The backing of your partner is vital during this time. (Resigning from your regular job to become a self-employed mural painter the week before your partner is due to deliver twins isn't likely to go down well.)

REMEMBER

- **Your relevant experience:** For example, if you're looking at buying a nursery, do you have horticulture training as well as hands-on retail experience? If you're considering going freelance as a consultant, do you have enough consulting experience behind you? (If you lack experience, buying an existing business or purchasing a franchise may be preferable to starting a business from scratch.)

Understanding economic influences

No business is an island but, rather, functions as an organic part of the world around it. Imagine owning a fantastic, go-ahead cafe in the Pilbara region of Western Australia. However cleverly managed, this café is at the mercy of whether local mines expand or shut down, whether the economy is booming or in recession and, further still, world commodity prices. Be aware of the following economic influences:

AHEAD OF THE PACK

- **Industry-specific events:** Be alert for changes in your industry that may affect the profitability of your business, such as additional licensing requirements, new government regulations or major shifts in available technology. For example, with the changes in financial planning regulations, many accountants are now restricted in the types of advice they can supply to clients.
- **Interest rates and currency exchange:** Some businesses are more affected by interest rate and currency exchange fluctuations than others. Importing, exporting, construction and real estate are just some of the businesses that can be affected, as well as any business with large borrowings. If you're likely to be affected by interest rate or currency exchange fluctuations, look carefully at economic indicators and plan accordingly.
- **Tax or government policy reform:** Many a good business has struggled because of tax reform. Think of a political football such as the solar industry, which is constantly subject to government funding changes. Keep abreast with industry news and anticipate, as much as you can, these changes before they happen.

I explore the impact of external influences on your business model in more detail in Chapter 3.

Planning in Dollars from the Start

If you're planning for profitability, I suggest you include detailed financial plans for everything you do. Quite what these plans include depends on whether you're just starting a new business, or whether your business is already established.

Starting with a new business

Here's a roadmap for building a robust financial plan for your new business:

1. **Establish a reliable, responsive bookkeeping system.**

   You need software that you can access using a web browser from wherever you might be in the world, and from whatever device you happen to be using, be it a phone, tablet or laptop. I talk more about setting up bookkeeping systems in Chapter 9.

2. **Draw up a detailed list of start-up expenses and calculate how much start-up capital you're going to need.**

   Skip to Chapter 4 for a checklist of start-up expenses to make sure you have everything covered.

3. **Explore how you're going to get your hands on this capital, and whether indeed this is possible.**

   How do you intend to finance the set-up expenses for this business? If you anticipate making a loss in the first few months, indicate how you intend to finance this loss. See Chapter 4 for more details.

   REMEMBER

   You may also want to draw up a separate budget for how you intend to survive while your business is getting established, and if necessary, add this amount to the start-up capital you require.

4. **Create detailed sales projections for the first 12 months.**

   Try to provide as much detail as you can with these projections, demonstrating the logic you use to arrive at the totals. I talk more about pricing your goods and services in Chapter 5, and creating sales projections in Chapter 6.

5. **Create detailed expense projections for the first 12 months.**

   Remember, things always cost far more than you expect! See Chapter 7 for more on this topic.

6. **Connect all the pieces together to create a detailed profit projection for the first 12 months.**

   This process can be a little tricky, but Chapter 7 shows you what's what.

7. **Calculate your break-even point.**

   Skip to Chapter 8 for more details about how to calculate break-even.

8. **As soon as you start trading, start reviewing your financial statements.**

   A weekly or fortnightly review of your Profit & Loss reports and Balance Sheet is essential. Chapter 9 explains how to understand these key reports.

Growing an existing business

If your business is already up and running, I suggest that the to-do list for your financial plan is a little different:

1. **Review your bookkeeping systems so that you can generate detailed financial and sales reports whenever you require them.**

   I talk more about setting up efficient bookkeeping systems in Chapter 9.

2. **Using last year's results as your starting point, create detailed sales projections for the first 12 months.**

   Try to provide as much detail as you can with these projections, analysing key sales trends and justifying any significant changes with details about these changes will be achieved.
   I talk more about pricing your goods and services in Chapter 5, and creating sales projections in Chapter 6.

3. **Create a detailed profit projection for the next 12 months, and compare these figures with results for the last 12 months, and perhaps even the 12 months before that.**

   Skip to Chapter 7 for more about profit projections.

4. **Calculate your break-even point.**

   I reckon the owner of any established business should know their break-even point off the top of their head. I explain this somewhat grisly topic in Chapter 8.

5. **Spend some time thinking creatively about how you can squeeze some extra profits from your existing business model.**

   In Chapter 3, I talk about spotting business opportunities and capitalising on your strengths. Chapter 5 offers lots of ideas for reviewing pricing, and Chapter 10 offers ten tips for gaining that extra edge of profitability in your business.

IN THIS CHAPTER

- » Drawing up your competitor scorecard
- » Figuring out what's so special about you
- » Choosing the best possible competitive strategy
- » Creating a plot to conquer the world (well, maybe not quite)

Chapter 2 Finding Your Competitive Edge

In this chapter, I explain why every business that's successful in the long term has a strategic advantage that's both hard to copy and valuable in the eyes of customers. Put simply, in order to make more profit than the others around you, you must first find something you do better, or something you could do better, than everybody else.

The next step is to mercilessly exploit this winning edge. With this in mind, I explain why you need to pick one, and only one, competitive strategy. This single competitive strategy, when combined with a winning strategic advantage, will lead you on the path to success.

Being the Best on the Block

If you're serious about making a profit, you need to do some serious analysis regarding your competitors. Without a clear understanding of the strengths and weaknesses of your competitors, you will have no clear idea of where the strongest business opportunities lie.

Watching and learning

Watch your competitors carefully, and you can pick up great ideas, avoid perilous pitfalls, and identify more clearly what makes you different.

Work through the following with your competitors:

- **Analyse prices super carefully:** If you're going to compete head-on with another business, you want to be right across the services that business provides, and the prices it charges. Unless a massive undersupply exists, charging $20 more per hour is probably pointless if you're providing an identical service to a close competitor.
- **Consider how people find this competitor:** What's the most likely avenue for most customers finding your competitor? Will they be searching by suburb, by specialty, or by services provided?
- **Find out who's struggling, and why:** Competitor analysis may provide the reality check that prevents you from taking unnecessary risks. For example, in my local town a whole strip of cafes come and go with every change in season. If I were thinking about starting a cafe, a competitor analysis may quickly reveal that the rents in this strip are hideously high, the tourist seasons are short, and nobody is making enough profits to survive, let alone thrive.

AHEAD OF THE PACK

- **Keep asking yourself what you do differently:** Unless you know exactly what your competitors provide, you won't know how to sell your differences.
- **Look for smart ideas:** Competitors' pricing specials, weekend packages, discount offers, creative advertising and clever sales techniques are just some of the things you may consider adapting for your own business. After all, imitation is the greatest form of flattery (although your competitors may not see it that way!).
- **See where you can capitalise on others' weaknesses:** For many people, the seed of a winning business idea is sown by not being able to receive good enough service or quite the right product. So they think, *I can do better than that*, and a new business idea or marketing strategy is born.

Table 2-1 shows a simple checklist where the owner of a copywriting business compares three other copywriting businesses, rating competitors according to what they do better (or worse).

TABLE 2-1 **Analysing Your Competitors**

Does this competitor . . .	ABC	CopytoGo	WriteNow
Have cheaper pricing than me?	Yes	No	No
Offer a faster turnaround time?	No	No	Yes
Offer specific services that I don't?	No	Yes	No
Offer onsite services, not just online?	No	No	No
Offer a larger variety of pricing packages?	No	No	Yes
Have more expertise/a higher level of skill?	No	No	No
Service different niches?	No	No	No
Have more testimonials than me?	Yes	No	No
Have a more active social media presence?	No	No	Yes
Have a stronger online marketing strategy?	No	No	Yes
Have more capital and power to expand?	No	No	Yes

By the way, when you're thinking about the competition for your proposed business, don't be too literal. Remember to include 'sometimes' competitors — companies that provide a slightly different service or product from yourself, or are in a different location.

AHEAD OF THE PACK

Along with 'sometimes' competitors, don't hesitate to compare your business against big-time competitors such as supermarket chains or large franchises. While you may find it hard to imagine how your fledgling business could ever compete, the mass-market nature of these competitors often leaves niches that are underserviced, providing opportunities for smaller players.

DON'T BE AFRAID TO PIKE OUT

I sometimes find that when people do an honest appraisal of their business idea and the competition, the resulting business proposal is found to be quite weak. Sometimes this is because the person starting up in business has limited skills or minimal capital; other times, the demand for their proposed product or service may not be strong enough. Other times again, competing against established players can be too hard.

If you're starting to question the strength of your business idea, don't be afraid to pike out. Stopping at this stage might save thousands of dollars, not to mention months or even years of your time.

If you're unsure whether your business idea is as strong as it could be and whether you should continue, what becomes relevant is measuring up the risks. If starting (or continuing with) this business means little capital outlay and a few lost weekends and holidays, you don't have much to lose. On the other hand, if this business involves your entire retirement savings and/or the threat of a failed relationship if things go wrong, the risk may well be unjustifiable.

Staying alert to future threats

In Chapter 3, I talk about how important it is to keep your eyes open to trends in the economy, the environment and in your industry. This macro way of thinking is particularly useful for imagining who your competitors could be in one, two or five years' time.

Ask yourself questions relating to the following areas:

- **Automation potential:** Could any existing competitors automate their processes using advanced technology and, therefore, become more of a threat than they already are?
- **Big players coming to town:** Could a franchise chain or large company move into your village, suburb or town and take lots of your customers? (In my village, the longstanding boutique wine store struggled when two big liquor chains moved within 3 kilometres.)

- **Buyout of minor competitors by a larger competitor with more capital and muscle:** Could one of your existing competitors be bought out by someone with more capital and better distribution and, in the process, become a very formidable competitor? (Think about how some smaller gourmet food brands have been purchased by supermarket chains and suddenly appear in every store.)
- **Changes in technology:** Could changes in technology mean your product or service becomes obsolete? (Think of the long-lost corner video store, the appliance repair technician or the 24-hour photo lab.)
- **Cheaper imports:** Could the goods you provide be substituted by imported goods if the exchange rate changes?
- **Customers doing it themselves:** Could your main customer or customers decide creating your product or providing your service in-house makes more sense? (Think of the big supermarket chains that now manufacture their own generic food lines.)
- **Life cycle of the business idea:** Is the life cycle of your business reaching maturity or beyond, meaning numerous competitors and fewer profits to go around? (Think of the mobile coffee vans that were once a clever niche business but are now a dime a dozen.)
- **Offshoring of labour:** Could the services you provide be performed offshore instead? (Almost anything that's mostly labour and can be done on a computer is vulnerable to offshoring.)
- **Service offered online:** Could the service you provide be sold online and, therefore, open to international competition? (Even some things that I would never have imagined could go online have done so. I don't go to my local yoga class any more, but instead log onto a yoga website that offers hundreds of pre-recorded classes to fit any duration, level or style of yoga.)

WHY YOU CAN SOMETIMES BEAT THE BIG GUYS

AHEAD OF THE PACK

When you're checking out competitors, you may come across lots of factors that make it tough for you to compete with the big guys in town, such as high capital costs, expensive IT systems or huge distribution networks. These factors are called *entry barriers*.

The flipside of entry barriers can be *exit barriers*. Sometimes competitors have invested so much in expensive rentals or specialised equipment, or sometimes competitors can be so management top-heavy, that they can't get easily out of the less profitable parts of their business, and also can't act quickly when opportunities arise.

For smaller businesses, these exit barriers sometimes point to opportunities. Maybe you can distribute product much more cheaply using the internet, while the competition is wedded to expensive retail rentals. Similarly, maybe you can act quickly in response to new fads or fashions, creating and promoting products in a fraction of the time a big company takes to do the same thing.

Identifying Your Strategic Advantage

Every business that enjoys long-term success and profitability does so because they've managed to secure a strategic advantage in comparison to the businesses around them.

A *strategic advantage* is something that stems from capabilities within your business that are hard for others to copy. These capabilities tend to be a unique blend of assets, knowledge, people networks, skills or technology. For example, imagine the owner of a mobile haircutting service has a background in nursing, and so has a natural understanding of the needs of her many elderly housebound clients. Imagine also that the owner's husband is a mechanic, which means the vehicle used for providing the salon's mobile service is kept on the road at minimal cost. This unique blend of skills and cost efficiency forms part of this salon's strategic advantage.

Finding your secret weapon

What is your strategic advantage? How can your business beat the competition, and what benefits can you provide that the competition can't? Here are some ways that your business may be able to secure a strategic advantage against others in the same industry:

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- **Added value:** Can you offer added value in comparison to your competitors? Think 24-hour delivery, locally sourced product, a mobile service, or a quality of product or service that's beyond industry norms.
- **Exclusive distribution rights:** Do you have exclusive distribution rights to a sought-after product or service?
- **First cab off the rank:** Do you have a new idea that nobody else has tried before? Or a new way of doing something that makes the product or service better, quicker or cheaper?
- **Intellectual property:** Do you have unique intellectual property (IP) that customers want and is hard to copy? IP includes copyright, patents and trademarks. If you're just getting started with your business, your IP could be as simple as a clever business name, an eye-catching logo or a well-chosen domain name (that is, a web address).
- **Location:** If you're a retailer, do you have a great location in a central shopping area? (Location is often the prime strategic advantage for retailers.) Or are you the only business providing a service in a particular suburb or region? Are the demographics of your location ideally matched to your business, or are you located in a central spot for freight and transport?
- **Lower costs:** Do you have an innovative way of doing things that reduces costs, creates economies of scale or significantly improves business processes?
- **Obsession and drive:** Do you have exceptional vision or drive? Is this drive connected with a particular obsession? (For example, think of Steve Jobs and his obsession about intuitive design.)
- **Perfectly matched team:** If you're in a business partnership of some kind, do you have a unique combination of skills and do you work well together as a team? (The synergy created by two or more people who have complementary skills and who work well together can be a force to be reckoned with, and something that's hard for competition to copy.)

- **Specialist skills:** Are you a specialist who has an insight into a particular industry that nobody else is likely to have? Maybe you can see a gap in the industry that nobody else is catering for, or maybe you can see a way to do something better.

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Think of a business that you know that has been really successful (maybe a local business or a friend's business, or even a big name such as The Body Shop, McDonald's or Microsoft). Go through the list of different strategic advantages and think about which of these advantages could apply to these businesses.

Uncovering your inner mojo

One good way to broaden your sense of where your strategic advantage may lie is to look at your existing customers and their buying patterns. (Or, if you haven't started your business yet, imagine what these answers might be.) Ask yourself these questions:

- When customers come to me, why is that?
- When potential customers go to my competitors instead, why is that?
- When potential customers make an enquiry but end up not purchasing my goods or services, why is that?
- Are the benefits I offer (or intend to offer) to my customers unique?

I like asking these questions because getting the answers usually means engaging in some market research. This naturally crosses over with competitor analysis, which I talk about earlier in this chapter (refer to the section 'Watching and learning').

AHEAD OF THE PACK

Honest, ongoing market research that compares the benefits your business provides to customers against the benefits your competitors provide is essential to business success.

Considering three key attributes

For a strategic advantage to be really worth something — in terms of the goodwill of your business or your likely profitability and financial success — this advantage has to be something that you can sustain over the long term.

I like to think that any really strong strategic advantage should have three attributes:

- **The advantage can't be easily copied by others:** The ideal strategic advantage is one that's really tricky for your competition to copy. Examples are a winning recipe or flavour (think Coca-Cola), a unique synergy of skills within your organisation, or expert knowledge that few others have.
- **The advantage is important to customers:** Think of the farmers who switched to growing organic produce in the early 1990s, before organics became more mainstream. Many of these farmers did really well because organics were so important to particular customers. (And although the advantage was relatively easy to copy, many authorities required a seven-year lead time with no chemicals before a farm could be officially certified.)
- **The advantage can be constantly improved:** If you can identify the thing that gives you an edge and constantly work this advantage, you have a strategic advantage that is potentially sustainable in the long term.

TRUE STORY

When Steve Jobs and Steve Wozniak started Apple, one key strategic advantage was that they were a perfectly matched team and they were passionate about design. The synergy of their skills was hard for others to copy, the beautiful design was something that customers really wanted, and Apple was in a position to continually improve and develop this advantage.

REMEMBER

Don't fall into the trap of thinking that because you're cheaper than everyone else, this is a strategic advantage. Being cheaper than everyone else usually means one of two things: Either your business isn't as profitable as it should be, or your competitors can grab your strategic advantage at any moment just by dropping their prices too. Usually, being cheaper than others is only a strategic advantage if you have some special skills, technology or volume of production that enables you to be cheaper.

Growing your advantages over time

Sometimes your strategic advantage isn't something that's blindingly clear from the moment you set out in business, but instead grows over time. Your skills grow as you develop in business, and your understanding of how you're different from the competition consolidates as well.

From time to time, you can review your strategic advantage by asking yourself these questions:

- What am I naturally good at? (Or what is my team good at?) Where do I feel I have been particularly successful in my business?
- What do I offer to my customers that's either cheaper than my competitors, better value or unique in some way?
- Does a point exist where what I'm naturally good at connects with what I do better than my competitors? If so, how can I build and develop this?

TRUE STORY

When our local osteopath first started out in business, he didn't really have anything that separated him from the competition. The only thing that was really different about him was that he was an elite rock climber in his spare time. However, as his business grew, he became expert at treating other climbers for their injuries. His business developed, and now he treats climbers who not only live locally, but also come from interstate. He even does some international consultations (and, yes, if you're wondering, some parts of an osteopathic consultation can be conducted via Zoom!). This combination of skills — being a natural climber and a highly trained osteopath — is hard to beat, and a true strategic advantage.

Picking Just One Competitive Strategy

Having a strategic advantage isn't enough. The next step is to leverage this strategic advantage with a view to making a decent profit for your business.

Any business, including yours, is faced with three possible competitive strategies. Pick one of these strategies, and only one, and run with it:

- **Be the cheapest:** With a *cost leadership strategy*, you're not necessarily the cheapest across all products you offer or the cheapest for every service but, in general, you're aiming to compete on price.

  TIP

  Cost leadership can be a winning strategy if your business has a strategic advantage — such as a technical innovation or exclusive distribution rights — that enables you to deliver your product or service more cheaply than your competitors.

- **Create a point of difference:** With a *differentiation strategy*, you set out to differentiate yourself in some way other than price.

  REMEMBER

  A differentiation strategy works best if you have a strategic advantage that enables this difference. For example, imagine an electrical contractor who has the strategic advantage that their spouse also has a trade license. This business could perhaps offer a 24-hour call-out service as a point of differentiation. Between them, they could offer this service without having to pay the penalty rates that other businesses would normally have to pay if sending an employee out on a job in the middle of the night on a Sunday.

- **Find a particular focus or niche:** With a *niche strategy*, your aim is to serve a specific market segment rather than deal with the whole market.

  Again, try to identify a relationship between your niche strategy and your strategic advantage. For example, maybe your strategic advantage is you've developed skills that few others can offer, such as a mobile butchering service, osteopathy for elite athletes, or social media services within a very specific industry. Your unique combination of skills or services is wasted unless you focus your marketing efforts on that particular niche.

REMEMBER

Always try to pursue a clear strategy. If you choose to muddle along not doing anything that's clearly different from others, you will find it difficult to both compete and establish a clear strategic advantage in the market.

SO WHAT'S SO SPECIAL ABOUT YOU?

Are you ready to take the challenge? Imagine you're stuck in an elevator and someone has just asked you what your business is all about. You reckon you have about 30 seconds to convey what your business concept is, what you do, and what makes you so special.

Click the Record button on your computer or smartphone, have a quick look at the clock, and record your reply in 30 seconds or less. Tick, tick, tick . . . stop. How did you go? Listen back and rate yourself out of 10.

Did you remember to include your name, your business name, what you do that helps others, and what makes your business different from others?

This 30-second 'elevator pitch' is surprisingly demanding. In this first stage of getting your business off the ground and developing a profitable business model, keep in mind that practice makes perfect. Say your speech aloud when you get in the shower, turn the ignition of your car, or make yourself a cup of tea. Your family may think you're a little bit potty, but that's a small price to pay.

Connecting the Dots

You may be feeling a little muddled as to how the concepts of strategic advantage, competitor analysis and competitive strategy interrelate.

But interrelate they do, with each concept triggering off one another. As shown in Figure 2-1, the process of comparing yourself against competitors, identifying your strategic advantage and choosing a competitive strategy is a continuous cycle of honing your business idea.

The trick for you is to pick a competitive strategy (focusing on cost, differentiation or a particular niche) that complements both your strategic advantage and any opportunities you've identified in the competitive landscape.

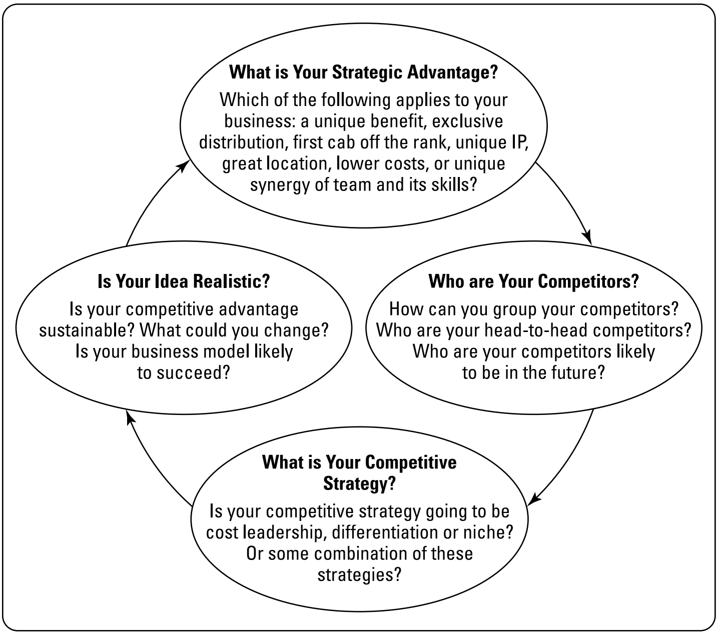

FIGURE 2-1: Use your strategic advantage, competitor analysis and competitive strategy to continually improve your business idea.

REMEMBER

Understanding what your business can do better or differently (including analysing your competitors, defining your strategic advantage and selecting a competitive strategy) is key to building a profitable business.

IN THIS CHAPTER

» Spotting industry trends and taking advantage of change

» Focusing on possible opportunities and threats

» Assessing your abilities (no holds barred)

» Matching strengths to opportunities, and guarding weaknesses from threats

Chapter 3
Staying One Step Ahead

Anticipating change, and responding quickly, is key to maintaining and growing the profitability of any business. I think with admiration of the craft beer brewers who, in response to the COVID-19 pandemic, teamed up with distilleries to make hand sanitiser, or the thousands of restaurants that shifted almost overnight to takeaway services.

In this chapter, I provide a few simple tools to help you plan for change while maintaining profit. I also explore the trusty time-tested SWOT analysis technique, and share how you can use this technique for the best possible chance of success.

Taking an Eagle-Eye View

To maintain the profitability of your business, you need an understanding of how the industry in which you're operating is faring, and what outside factors may affect this industry in the near future.

Imagine you were the owner of a video and DVD rental business 30 years or so ago when this industry was thriving. Maybe your business was very profitable (you had great taste in movies, your shop was in a central location and you had no competitors).

Despite all these advantages, chances are, unless you were able to pivot not only quickly but also extremely dramatically, you would have ceased trading by now.

Looking at what's happening in your industry

If you've been working in an industry for a while already, you probably have a feeling for general industry trends on an intuitive level. However, I recommend you take time to think more analytically about all outside factors that influence your business, such as the economy, the demographics of your target market, and the average profitability and trends of this industry.

This analysis is known as a *PESTEL analysis*, standing for political, economic, social, technological, environmental and legal. The primary purpose of analysing the environment in this way is to identify the drivers of change affecting future industry growth.

Here's what you should focus on:

AHEAD OF THE PACK

- **Political:** What political forces could affect the industry? For example, think about how marketing-savvy solar panel retailers were able to benefit from solar rebate policies, or how building contractors were able to expand their workforce at short notice have benefited from government stimulus plans.
- **Economic:** How might interest rate changes or exchange rates affect your industry? How can you safeguard your profitability in an industry that's vulnerable to such fluctuations?
- **Social:** How might you benefit from changing demographic trends? For example, can you see any business opportunities in the growing population of retirees?
- **Technological:** How might your industry be affected by technological change? Look for ways that you can benefit from being an early adopter of technical innovations, software apps or distribution portals.
- **Environmental:** Can you benefit from increasing consumer expectations that your industry be environmentally conscious?

» **Legal:** Increasing government regulations can often serve to polarise an industry, especially if compliance is very expensive. These extra costs can make an industry more profitable for the larger players but tougher for the small fry.

Table 3-1 provides a summarised analysis I did for an established regional accounting firm — you can see that even for a business as stable as this, many forces can shape future profitability. This industry analysis identified not only opportunities, but also areas of the business that may be prone to a decline in profitability.

TABLE 3-1 Industry Analysis — Regional Accounting Firm

	Industry Change	Likely Consequence
Political	Superannuation reforms	Possible decline in demand for self-managed super funds
Economic	Increasing downward fee pressure	Growth in larger firms able to implement cost-saving processes
Social	Demographic changes as baby boomers move into retirement	Growth in demand for retirement planning
	Different expectations from Gen Y clients	Pressure to be more interactive and technologically adept
Technological	New technology that enables clients to perform their own tax returns	Decline in routine compliance work
	Video conferencing and email replacing face-to-face contact	Erosion of niche markets based on location, but reach potentially expanded to nationwide
Environmental	Demand for accountants to report on non-financial performance	Growth in demand for sustainability reporting
Legal	Increased regulation of self-managed super funds	Growth in specialist firms providing super services only

As part of researching these outside influences, I recommend you hunt for 'state of the industry' reports wherever possible. These reports are often published by industry associations and available for free download from their websites. In addition, see if you can find financial benchmarks for your industry. Such profiles often include handy info about employment, average income and average operating profit before tax.

Being realistic about industry decline

The idea behind industry analysis is to gain a sense of what's happening in the industry, and where opportunities for additional profits may lie. Of course, an industry that's in decline is going to be a whole load tougher (if not impossible) to succeed in than an industry that's growing very quickly.

REMEMBER

If your industry is in severe decline, your best bet is probably to try to sell your business, close your business if it is already unprofitable or, if you're still at the planning stage, walk away from the idea of starting a new business. Closing a business can be particularly scary, because you may have significant funds invested that you'll never recoup. However, if you're already trading at a loss, selling your business in the context of a declining industry may be impossible. The longer you trade unprofitably, the more you stand to lose financially.

Riding the wave of opportunity

Generally, industry growth is a great thing for anyone involved and, if you're in the right place at the right time, you can make handsome profits.

For start-up businesses, if you can find a niche that works, I believe the opportunities are greater than ever. Each time I look around these days, I spot another ingenious business idea that seems to be thriving — whether this is a queer gym, an online business helping Chinese parents choose 'Western' baby names, or a restaurant in Amsterdam installing a dozen greenhouses in its forecourt to manage social distancing.

WARNING

The flipside of jumping on the bandwagon for any industry experiencing rapid change can be higher risks, because the direction of change and new technology can be hard to predict.

TIP

Part of the secret to mitigating the risk in any industry going through change lies in matching the internal strengths of your business against the potential opportunities of the industry — which is exactly what the rest of this chapter is all about.

Identifying Opportunities and Threats

In order to spot business opportunities as they arise, the name of the game is to try to anticipate the impact that changes in the overall economy or in your specific industry may have on your business.

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For each of the following categories, ask yourself what opportunities and threats lie in store. Remember that any change can be an opportunity or a threat (or even both), depending on where you stand in the scheme of things. Organise these opportunities and threats in two columns, similar to Table 3-2. (Although bear in mind that Table 3-2 is a somewhat simplified example — your list will almost certainly have a bit more detail.)

Consider the following:

- **New competition:** How likely is it that new competitors could affect your business? Do you have special skills or a strategic advantage that safeguards you from competition? (I talk more about competitor analysis and strategic advantage in Chapter 2.) Or is the thing that makes your business so successful easy to copy? What if the competitor has more capital, a better location or superior marketing abilities?
- **Emerging technologies:** How is technological change going to affect your business? Could new technology end up putting you out of business? Or are you skilled in the direction that new technology is heading, and could this be an opportunity?
- **Changes in demographics:** Demographic change is a long-term thing, but so (hopefully) is your business. If your business serves a local population (as opposed to having national distribution or being online), it pays to watch the trends in population patterns. (Running a children's toy store in a suburb with a rapidly growing retiree population and a declining birth rate may not be the most brilliant strategy ever. However, marketing quality products to cashed-up and indulgent grandparents could turn this into an opportunity.)

REMEMBER

- **Changes in government regulations:** If your business is dependent in some way on government regulations (maybe you're a taxi driver, you work in health, or your business relies on government grants in some form or other), you're particularly vulnerable to changes in the political landscape. Ask yourself what impact changing regulations could have on your business, and how you could respond.

- **Changes in the economy:** Is your business very dependent on the ebb and flow of the economy? Some businesses (for example, a business selling staple food products) are relatively stable regardless of what's happening in the economy; other businesses (such as those selling high-end luxury goods or even tourism) tend to move in tandem with booms and busts.
- **Changes in your domestic affairs:** If you're a small business, I know (from experience!) the impact that changes in your home life can have. A divorce can split business assets in two and turn a viable business into a struggling one, or the need for your family to move to another town for your spouse's job can dramatically affect your business. So if you think that a change of this nature is possible, don't be shy to include this in your plan.

TABLE 3-2 Summarising Opportunities and Threats

Opportunities	Threats
Analysis for iPhone app development company	
Steady growth in demand	Growth in number of competitors
Opening up of labour market means possibility to hire overseas programmers at lower rates	Offshore labour market means new competition often at very low prices
Some clients willing to sign up for profit-share arrangements in lieu of lower charges	Changes in programming languages mean hard to keep up, especially with small employee base and high cost of training
Lots of government contracts available as government bodies seek to create new apps for community info	Strong trend towards android phones, and expectation from clients for apps to be available for androids as well as iPhones
Analysis for solar panel installation company	
Huge growth in demand	Some serious new competitors with major muscle
Depending on changes in government, potential additional subsidies for consumers	Exclusive distribution licence ends in two years
Schools and government bodies recommended by their own policy to stick with local suppliers	Rapid growth requires high borrowings and puts pressure on cashflow
	If new government, all subsidies could finish

IT'S COOL TO BE GREEN

One overriding long-term global trend that's unlikely to change any time soon is the growth of environmental awareness, and the resultant demand for ecological products and services. Couple this with the growing impacts of climate change, and you end up with a perfect example of something that is both a business opportunity and a business threat.

For those in the 'green' industry (ecological products, alternative energy, environmental consulting and so on), this long-term trend presents an opportunity. For those in industries with high energy demands, particularly those dependent on fossil fuels, this trend is a threat.

When you're thinking about opportunities and threats for your business, you may also want to refer to the industry analysis process outlined earlier in this chapter (in the section 'Taking an Eagle-Eye View'). However, keep in mind that opportunities and threats in this context have a different scope than just one particular industry. For example, a global recession or a change in government isn't industry specific. Or, at the other end of the scale, the arrival of a new competitor may be a reflection of a growing population in one geographic region rather than an indication of general industry trends.

AHEAD OF THE PACK

Some things don't fit neatly into boxes as an opportunity or as a threat. Be willing to get creative. Although your analysis of threats and opportunities usually reflects your current position, stay open to new possibilities, and see if you can find ways to view threats so that they become opportunities.

Rating Your Strengths and Weakness

Trying to overcome your shortcomings is undoubtedly character building and often deeply rewarding. However, in the world of business, being more strategic about where you channel your energies usually pays off. If possible, you want to try to match your natural skills and abilities against the business opportunities that arise.

Ready to put yourself through the griller? For each skill listed in Table 3-3, rate whether this is an area of strength or weakness for your business. In the next column, rate whether this skill is important for your business, or not.

TABLE 3-3 Identifying Strengths and Weaknesses for Your Business

Skill	Strength or Weakness?	Important? (Yes or No)
Marketing instincts		
Social media savvy		
Written communication skills		
Ability to sell anything to anyone		
Bookkeeping skills		
Ability to understand financial reports		
People-management skills		
Business experience		
Staff team morale		
Physical location of your business		
Standard of customer service		
Reporting systems and databases		
Business website and office IT systems		
Range of products or services offered		
Technical expertise of staff		

REMEMBER

When you consider the skills listed in Table 3-3, respond from the perspective of your business, rather than from you as an individual. Think of the collective skills that you, your employees, any family members, business mentors or outside consultants bring to the party. Also, keep your competition in mind when you rate your business on things such as customer service or marketing. (For example, you may be aware of small areas where you can improve your customer service but if you know that you beat all of your competition hands down, you can probably count this area as a strength.)

WARNING

When rating how important each function is for your business, I suggest you put a tick in the 'Yes' column for all aspects of financial management. Even if your business chugs along just fine and you're a shoebox-receipts kind of person, poor financial management is almost always a limiter to business profit and growth.

The combination of something being both important to your business but a weakness in the skillset of your business is an unhappy one. Can you identify any business functions in which you're really weak, but which are crucial for your business?

Doing a SWOT Analysis

If you've read any other business books or worked in larger organisations, you've probably already heard of a SWOT analysis (strengths, weaknesses, opportunities and threats). As a model, the SWOT analysis sticks around while other business concepts come and go, simply because this way of looking at things is both easy to understand and surprisingly powerful.

Piecing the elements together

The idea of a SWOT analysis is simple:

- Aim to build on your strengths but minimise your weaknesses.
- Endeavour to seize opportunities and counteract threats.

Are you ready to try your own SWOT analysis? Then here goes:

1. **Make a list of the strengths and weaknesses of your business.**

   I explain how to do this earlier in this chapter in 'Rating Your Strengths and Weaknesses'.

2. **Make a list of possible opportunities and threats.**

   Refer to 'Identifying Opportunities and Threats' to find out how.

3. **Draw a grid similar to Figure 3-1.**
4. **Divide your strengths into two categories: Strengths that can help you take advantage of opportunities, and strengths that can help you deal with threats.**
5. **Write down these strengths in the first row of your SWOT grid, along with the related opportunities or threats.**

   Strengths that help realise opportunities go in the top-left; strengths that could help counteract threats go in the top-right.
6. **In the same manner, divide your weaknesses into two categories: weakness that may hinder you taking advantage of opportunities, and weaknesses that may make threats even more of a threat.**
7. **Write down these weaknesses, as well as the threats, in the second row of your SWOT grid.**

   Weaknesses that hinder opportunities go in the bottom-left; weaknesses that exacerbate threats go in the bottom-right.

Business SWOT Analysis		
	OPPORTUNITIES	**THREATS**
STRENGTHS	*Write strengths that assist with opportunities here, along with a description of the opportunity*	*Write strengths that help counteract threats here, along with a description of the threat*
WEAKNESSES	*Write weaknesses that may hinder you from exploiting opportunities here, along with a description of the opportunity*	*Write weaknesses that may compound threats here, along with a description of the threat*

FIGURE 3-1: The principles of a SWOT analysis.

Making a plan of action

After you've completed your SWOT analysis (refer to preceding section), what next? Put simply, this grid encapsulates four different business strategies:

REMEMBER

- **Exploit:** Aim to exploit any areas where your business is strong and is a good fit for an opportunity.
- **Watch:** Keep a watchful eye on any areas where your business is strong, but a threat may be looming.

- **Improve:** Try to improve on any areas where your business is weak but opportunities exist. (For example, you could consider extra training, hiring employees with different skills, or employing consultants.)
- **Pre-empt:** Take pre-emptive action and attempt to get rid of any areas in which your business is weak but a threat is looming.

TIP

Try to express these strategies using goals that are very specific and have a timeframe. For example, 'A weakness in our business is our limited experience in creating android apps. We will attempt to hire a new employee with these skills within the next three months.' Or another example: 'A clear weakness in my business is the lack of financial skills and also the general lack of attention to my finances. I plan to focus on financial management with an aim to being able to produce and review my own Profit & Loss every month. If this proves too difficult, I will employ a casual bookkeeper.'

IN THIS CHAPTER

» Making sure you have enough dosh to get started

» Ensuring you have sufficient working capital to sustain fast growth

» Choosing the right kind of finance for the job

Chapter 4 Guarding Your Working Capital

How much cash does your business need? Lots of it, of course! And however much you have, there's usually not quite enough.

An essential building block for profitability is ensuring you first have enough capital to kickstart your business and then later, enough working capital to sustain a healthy level of growth.

In this chapter, I explain how to calculate how much capital you need to get started, including the costs of set-up, underwriting your business as it gets established and, if necessary, paying for personal expenses in those first few difficult months.

I also talk about maintaining cashflow as your business grows, as well as the different kinds of finance available and how to best match this choice of finance to your business needs.

Budgeting Enough for Start-Up

Business start-up costs are often much higher than you imagine, with things such as council fees, insurance, legal fees and rental bonds being just some of the expenses that people forget to budget for. This section looks at budgeting for start-up expenses, making sure you have enough to live on, and assessing how much you may need to borrow.

Creating a start-up budget

If you're still at the initial planning stage of your business, read through the following lists, which itemise many of the key expenses you need to budget for when starting a new business:

- **New equipment or tools:** Expenses here include IT systems and peripherals, motor vehicles, office furnishings, retail equipment (cash register, point-of-sale software), and tools and other equipment.
- **Premises fit-out:** Budget for council fees, fit-out of new premises, lease agreement fees, rental bond and rent in advance.
- **Other start-up expenses:** Accounting fees (advice for new set-up), consultant fees, incorporation of company, insurance (public liability/business indemnity/property insurance), internet connection and networks, legal fees, licence fees, marketing and branding (including business logo and registration of business name), security bonds for electricity and gas, signage, stock for resale, training of staff and website design all may need to be budgeted for.

Of course, service businesses tend to have fewer start-up costs than retail businesses (a retail fit-out typically costs well over $100,000) and, if you're purchasing a franchise, you need to add in the franchise purchase price as well as the ongoing monthly retainer while you're still getting things off the ground.

AHEAD OF THE PACK

While your budget for start-up expenses is an essential first step, this budget doesn't necessarily provide a clear indication of how much you need to borrow — you only know that for sure when you complete the rest of your business and personal budgets.

Adding enough to live on

Most businesses don't make any profit in the first six months and, in fact, many businesses make a loss during this time. For some businesses, the period before you see any profits may be a year or even longer. You may find that you not only need to borrow funds to get your business up and running, but also need some additional funds in order to finance your living expenses in the first few months.

Quite how you budget for living expenses depends on your circumstances, and whether you're continuing to work another job while your business gets established. If need be, I suggest you ask for help from your accountant or business advisor to create a personal budget, or that you avail yourself of one of the many personal budgeting apps available on your mobile phone.

Assessing how much you really need

By now, you should have an idea of how much start-up capital you require for equipment, vehicles, and office or shop fit-out, as well as how much you need (if anything) for opening stock. In addition, you've started thinking about whether you need additional funds to cover your living expenses while you get yourself established.

At this point, you can start thinking about three things:

- If you don't have the necessary savings, will you be able to borrow the money?
- How much finance will you need, and what will the likely repayments be?
- Will these repayments be affordable in the first year or two of your business — or will this level of borrowing bring an unacceptable level of risk and/or stress?

Depending on the answers to these questions, you may want to review your start-up budget. Although you don't want to risk business failure by being under-capitalised, you may find that you can pull back or delay on some spending without the business suffering unduly.

Here are some tips for pruning your start-up budget:

- **Consider leasing rather than buying assets outright:** Finance that's secured against an asset such as a vehicle is usually pretty easy to obtain, and preserves your cash so that it can be used as working capital instead.

- **Be realistic about spending precious funds on a new car:** You may want that brand new speed-machine, but unless your vehicle is an essential part of the brand and image of your business, you can almost certainly do without.
- **Consider buying stuff second-hand:** Again, second-hand stuff isn't as glamorous as new and shiny stuff, but may do the job just as well.
- **Look at renting equipment**. If your budget includes new equipment, consider whether you could rent this equipment on an occasional basis while your business builds up.

Keeping Cash Flowing

When a business grows quickly, it gets hungry for cash, requiring more equipment, more stock and more employees. Often, businesses end up needing finance not because they're struggling, but because they're so successful.

I recommend you keep tabs on how much working capital your business needs, both for current requirements and for any growth that you plan. By *working capital*, I mean the difference between your current assets and current liabilities, with current assets meaning anything that can be converted quickly to cash (such as invoices from debtors), and current liability meaning any expenses that will be due within the next payment cycle.

Understanding sustainable growth

One paradox of business is that if you get too successful, too quickly, you can actually send yourself broke. Just in case you think I'm talking out of my ear, here's my logic.

As your business grows, you need more cash, more furniture, more computers and so on. The amount of money that customers owe to you is also likely to increase. The new assets take up cash; in order to pay for them, you need to first make a profit and, second, invest this profit back into the business. However, if you grow too fast, you need new assets faster than you can make and invest your profit.

MONEY STUFF

This concept of too-fast growth is often called the *limit of sustainable growth*. Without delving too much into the mathematics, as your business grows, your assets generally have to grow too. You can either finance these assets by reinvesting profits or you can finance these assets by taking out a loan. For example, if you can invest enough profit to increase cash, debtors, equipment and so on by 10 per cent a year, your business can comfortably grow at 10 per cent a year.

An example may help. Imagine that your business has a turnover of $500,000 a year and you have around $100,000 tied up in stock, computer equipment and outstanding customer accounts. After paying your wages, if your company makes a profit this year of $15,000, and you have to pay $5,000 tax on this profit, this result means you have only put $10,000 back into the business.

The $10,000 you have available to reinvest divided by $100,000 (which is the total value of cash plus debtors plus equipment) equals 10 per cent. This year's turnover of $500,000 plus 10 per cent equals $550,000, meaning that an increase in turnover of $50,000 is the maximum you can grow your business in the next year without having to seek extra finance.

REMEMBER

The pace at which a business can comfortably grow *is* limited: To be very successful, too quickly, runs the risk of putting such a strain on your cashflow that, unless you can secure additional finance, your business may not survive.

Surviving a growth spurt

Here are some finance tips for surviving a growth spurt:

REMEMBER

- **Don't use up cash buying new assets:** Even if you've got $20,000 sitting in your bank account, avoid paying for things such as cars or new equipment with the cash. (If your business is growing fast, excess cash is soon in high demand to pay tax bills, increase stock or offer more credit to customers.) Instead, sign up for a lease, chattel mortgage or hire purchase and spread the repayments over a few years.
- **Slow down your growth, if you can:** It's exciting when you think you're onto a winning idea, but slow, steady growth is much easier on your cashflow. Go one step at a time and, as much as possible, let the profits from one stage finance the next.

» **Use business loans or lines of credit, rather than overdrafts or credit cards:** A growing business uses up credit in no time at all, and then finds it hard to pay back. When your business is established with good, strong growth, a business loan or line of credit is your best option.

Sizing Up Your Finance Options

Take the time to consider the different types of loans or credit available and ensure you get the right kind of finance for each situation.

Your options include the following:

MONEY STUFF

» **Finance for initial working capital:** Your personal savings, a line of credit, business loan, home equity loan or equity partner is usually the best way to raise the initial capital for your business.

» **Finance for new equipment or motor vehicles:** Leases, chattel mortgages or hire purchase usually work best, with the asset itself providing the security for the loan.

» **Finance for short-term trading fluctuations:** Overdrafts and credit cards can tide you over in tricky times, although they're an expensive form of borrowing, especially if you're always in the red.

I talk about each of these kinds of finance in the next sections.

Taking out a business loan

Unfortunately, if you're looking for a business loan for a new business, and you don't have some security (such as your home) to offer as a guarantee against the loan, you've got a very slim chance of getting your loan approved. Even if you do have equity in your home, many banks aren't prepared to take a risk until a business is established and you have a proven income stream.

If the bank *does* come good with approving a loan, you're likely to get a choice between a line of credit and a business loan:

» A *line of credit* works a little like a regular banking transaction account, except the balance is in the red, not the black. You can use the loan for all your business banking, including both deposits and withdrawals. You have a credit limit on the account, and it's your choice whether you pay off the principal or pay interest only. This form of borrowing is less common than it used to be and can be tricky to obtain.

- A *business loan* works more like a regular home loan — you borrow a certain amount and commit to regular repayments over a certain number of years.

What type of business loan is going to work best for you? On the upside, a line of credit is wonderfully flexible but, on the downside, you have to have a disciplined nature to force yourself to pay off the debt. (If you never reduce the principal outstanding on your line of credit, you end up paying more interest than you would on a regular business loan.) With business loans, the upside is you get it paid off quickly. The downside is the bank usually offers a relatively short term (five years is quite standard), meaning that repayments are high when the business is least able to afford it.

Almost all banks require some security against borrowings, and this rule normally means the owners or directors put up their own home as collateral. I know how scary putting up your own home as security can be, but the more security you offer, the lower the cost of the loan (interest is normally charged at normal variable rates, plus a risk factor that the bank assesses, which is usually between 1 and 3 per cent).

REMEMBER

Even if the business loan is in your name only, remember that if you guarantee this loan against a property that's jointly owned, *both parties* (that is, both you and your best beloved) are jointly liable. This means that even if the relationship breaks down or one partner suffers ill health or dies, the other person must continue and take over the whole payment.

Finding a new lease of life

The idea behind leasing a new vehicle or new equipment is that a finance company buys the asset on your behalf and then rents it to you. You pay the rent every month for an agreed amount of time, and then, if you like, at the end of this period you can buy the asset from the finance company for a reduced price (this reduced price is usually called a *residual*). All your lease repayments are tax deductible.

REMEMBER

MIXING HOME AND BUSINESS

Redrawing against the equity in your home loan is an easy and common form of business borrowing. However, if you end up with a single mortgage shaped as a combination of personal and business borrowings, calculating how much interest expense is personal and how much is business gets pretty tricky.

The same issue crops up if you redraw funds for personal purposes from a business loan (for example, to pay a personal tax bill or renovate your home). Because you're mixing personal and business borrowing, the interest on this loan is no longer 100 per cent tax deductible and, potentially, the Australian Tax Office can question whether you're able to claim any of the interest on this loan at all.

You can avoid your claims for interest deductions getting knocked back by keeping your home and business borrowing completely separate. If you want to borrow against the equity in your home, ask for a split loan facility, where you end up with two loans using the same security. Similarly, if you have a business loan and you're ahead on the repayments, make a redraw only if you intend to use the redrawn funds for business purposes.

Here are a few reasons leasing works well for small businesses:

MONEY STUFF

- **Leasing terms are flexible:** Your monthly repayment depends on three things: The interest rate, how long the lease runs and the amount of the residual (also sometimes called a *balloon payment*) that you have to pay at the end. (You're best to make this balloon payment as small as possible, so that you don't end up paying out a heap of dough for something that isn't worth much and you can't afford to replace.)
- **Leases are relatively easy to obtain for existing businesses:** For existing businesses with proven cashflow, leases are relatively easy to get because they're secured against the asset itself. (In contrast, new businesses may find the finance companies unwilling to offer a lease and, if they do, the lease terms are likely to be expensive.)

» **Leasing is easier when cashflow is tight:** Because leasing doesn't require an upfront deposit, monthly repayments are often more manageable than one big lump sum. If your business is seasonal, you can even arrange lease repayments that allow you to pay more in the busy months and less in the slow months.

REMEMBER

» **Leasing allows for some flexibility with tax deductions:** You can claim monthly lease repayments as a tax deduction, and if you've got enough ready cash when the end of the tax year comes around, you may even be able to pay 11 months in advance, and receive the whole amount as a tax deduction that year (do check with your accountant first, however!).

» **Leases may provide a good way to keep your business up to date with the latest technology:** Some leases let you upgrade equipment simply by terminating the old lease and taking out a new lease. However, check the balloon payments and lease conditions carefully, because many leases require a payout higher than the item is worth.

CROWD AROUND

Crowdfunding (also sometimes called *crowdsourcing*, *crowd financing* or *crowd fundraising*) is an increasingly popular way to raise funds for your new business idea.

Crowdfunding operates in one of two possible ways. The first way is rewards-based crowdfunding, which allows people to contribute money to a project that has yet to be completed, or a business that has yet to be started, in exchange for some kind of reward. The rewards vary from project to project. For example, I recently contributed to a crowdfunding campaign for a community arts festival in my town. In exchange for my $50, I received an invitation to the opening party. I could also have chosen to contribute $500 in exchange for advertising in the festival program.

The other way that crowdfunding operates is through equity crowdfunding, where investors pay to own a slice of a company.

Are you wondering whether crowdfunding is a possible way for you to raise funds for your business? New crowdfunding platforms launch almost every day, but Crowdfunder, Indiegogo, Kickstarter, Patreon and Pozible are all established platforms with high participation rates.

REMEMBER

You can get hit with a load of penalties when you pay out a lease too early. For this reason, choose the term of the lease carefully and do your sums before deciding to sell a leased asset.

Getting hitched with hire purchase

Chattel mortgages and commercial hire purchase are very similar to leasing, but with a few key differences:

REMEMBER

- **Ownership:** With a chattel mortgage (but not with hire purchase), *you* own the asset, not the leasing company.
- **Tax deduction method:** Instead of claiming the entire monthly repayment as a tax deduction, you're allowed to claim the depreciation on the equipment or vehicle as well as the interest on the loan. Usually, this arrangement means you get a bigger tax deduction in the early years of the agreement than you would with a lease.
- **No residual:** Chattel mortgages and hire purchase agreements don't usually have a residual. This means when you finish your monthly repayments, you don't have a big lump sum to pay at the end.
- **Goods and Services Tax (GST) reporting:** Depending on the nature of the agreement and the method you use to report for GST, you may be able to claim all the GST back in one lump sum at the point you purchase the new equipment or vehicle. Check with your accountant to find out more.

No hard-and-fast rule exists to help you determine which is the best option — leasing, chattel mortgage or hire purchase. If you're not sure which is best for you, I suggest you chat to your accountant.

Staying careful with credit

In the perfect world, credit cards are simply a handy facility. You can pay bills over the phone, fix up expenses when travelling or use them to tide you over if cash runs short one month.

Most corporate credit cards are set up so you have to repay the whole balance each month, usually via a direct debit from your business bank account. However, many small business people don't have a corporate credit card and, instead, use their personal credit card to pay for business expenses.

This scenario is where you can get into trouble: Personal credit cards are not only terribly expensive — especially if you're strapped for cash and end up paying the minimum monthly payment only — but also sickeningly easy to get hold of. I remember consulting to a couple who had taken out a new credit card loan every time cash ran short. They ended up with 11 credit cards between them and a cumulative debt of $80,000!

WARNING

Credit cards are great as a short-term credit solution, but when used for long-term borrowing, they're an extremely expensive option.

Seeking equity partners

So far in this chapter, I only talk about *debt finance*, meaning that to get cash for your business, you go into debt. However, the other major source of business finance is *equity finance*. With equity finance, you receive funding from an investor in exchange for a portion of ownership of your business. Equity finance is more popular in the United States than in Australia, but the industry is growing fast.

MONEY STUFF

The idea with most equity finance is that investors — sometimes referred to as *business angels* — buy into your company, offering funds and expertise in return for part-ownership. The investors don't receive interest on these funds, but instead are looking for a return through long-term capital gain. Because the investors are exposed to the risk of your company failing, they usually look for businesses with a strong history of growth and higher-than-average returns.

The advantages of equity finance include the ability to raise funds even if you don't have security or collateral to offer, meaning that your financial structure is more stable. In addition, your business can hopefully benefit from the investor's management expertise. On the downside, an outside investor means you no longer have complete control of your business. You may find it hard having to consult others before making decisions, especially if you're used to running your own show.

THE HIDDEN PRICE OF (SOME) FAMILY LOANS

TRUE STORY

If you're considering borrowing funds from your family, I suggest you think through the possible consequences very carefully first.

Several years ago, one of my clients borrowed a large sum of money from his father to start a business. I had thought that this was a family loan that had worked very well, as my client had repaid his father assiduously over several years. However, I discovered later that my client's sister had been, and still was, very upset about this loan. It turned out that she had approached her father for finance as well, but her father had said he couldn't lend her anything, because he had no money left to lend. The sister had missed out on the purchase of the farm she wanted, and nursed a resentment against her brother for years.

You will find many ways to make a profit in your lifetime but you will only have one family, and your family relationships are probably more valuable than anything else you have in your life. If you're considering borrowing from your family, pause first to think how other siblings may feel and what would happen if you failed to repay these funds. If your siblings could feel resentful or your family would suffer in any way if you failed to repay these funds (and failure in business, no matter how optimistic you currently feel, is always possible), then think again. You may be better to borrow from a different source, or postpone your business venture.

IN THIS CHAPTER

» Using smart pricing for bigger profits

» Capturing the market with a mix of price strategies

» Reviewing your pricing, step by step

» Staying on top of your game

Chapter 5 Pricing for Profits

Here's the takeaway for this chapter: Don't be tempted to undercharge for your products or services. Instead, try to hold your nerve, even if you're anxious that unless you're the cheapest, you won't secure enough business to cover your expenses.

By undercharging, I'm talking about charging less than your customers are willing to pay. Precisely what this amount is can be tricky to judge, especially if you're pricing a service rather than a product. However, taking the time to establish this value is key to clarifying your business strategy and growing your profits.

In this chapter, I talk about pricing strategies, and explain how every business, no matter its size, needs to consider the options of premium, standard and discount pricing, not to mention package and differential pricing. I realise all these terms may sound complicated, but stick with me — this kind of smart pricing is key to growing the profitability of your business.

Choosing a Pricing Strategy

Business educators use a heap of different terminology for price strategies, but essentially any price strategy boils down to one of three things: *Cost-based pricing*, *competitor-based pricing* or *value-based pricing*. In order to help your business finances thrive, it pays for you to understand how each of these strategies work.

Setting prices based on costs

Cost-based pricing is where you start by figuring out what it costs you to make a product or provide a service, and then you add an additional amount to arrive at the profit that you're after.

For example, imagine I decide to start a business selling sunhats at the local markets. The hats cost $8 each to buy, the stall costs $100 rent for the day and I reckon I can sell 50 hats a day. I want to make $250 profit to cover my time, so this means I decide to charge $15 per hat. (Sales of $15 × $50 = $750; less the $400 for the cost of the hats, less the rent of $100, and I'm left with $250 in my hot, sticky hand.)

This pricing model may sound like perfectly logical, good business practice, but it's not, because this way of working doesn't pause to consider how much customers are actually prepared to pay for these hats. Maybe another stall opposite is selling the self-same hats for only $12. Maybe the hats are a real bargain and I should be charging $20.

REMEMBER

From a strategic perspective, cost-based pricing is the weakest of all business models. On the one hand, if the resulting prices are too high in relation to the competition, the business will flounder; on the other hand, if resulting prices are less than people are prepared to pay, you'll miss out on the possibility of above-average profits.

Setting prices based on competitors

Competitor-based pricing is where you look at what your competitors are charging for similar products or services, and then set your prices accordingly. This pricing strategy is the most common strategy used by business.

As I mention in the introduction to this chapter, if you're just starting out in business, you may fall foul of the temptation to be cheaper than everyone else. However, unless everyone else in the industry is driving around in sports cars with money to burn, chances are your competitors' prices are the level they are for a very good reason. Unless you have a competitive advantage that enables you to produce products or provide your services cheaper than your competitors, setting your prices lower than everyone else is likely to lead to poor profitability for you, as well as a risky business model.

Instead of trying to undercut competitors, look at the prices that your competitors are charging and use this analysis as a reflection of what the market is prepared to pay. Then pitch your pricing accordingly.

AHEAD OF THE PACK

Competing on price alone is always a dangerous strategy. Sure, you need to be aware of competitor pricing and factor this information into your pricing decisions. However, how you position and sell your products and services should almost always be based on a combination of many different factors, such as quality of product or quality of service, delivery times, location, availability and ambience, and never just price alone. (For more about identifying your competitive strategy, refer to Chapter 2.)

Setting prices based on perceived value

Value-based pricing is where you reflect on the products or services you provide, look at the customer demand, and then set your price according to how much you think customers will be prepared to pay.

Here are a few examples of value-based pricing:

- Apple use value-based pricing for many of their products (sought-after items such as iPads and iPhones), where no direct head-to-head competition exists and customers are prepared to pay premium prices for a brand upon which they place a high value.
- The stallholders selling umbrellas outside Sydney central station push up the price of umbrellas by $3 or $4 every time it rains. Why? Because customers place a much higher value on staying dry when the rain is bucketing down.
- I know of a very gifted network engineer who has earned an almost god-like status among local businesses for being able to troubleshoot and solve network issues when everyone else has failed. He charges top dollar — significantly more than his competitors — but people will pay because they place such a high value on having reliable business systems, and getting those systems back up and running quickly.

In many ways, value-based pricing represents the essence of good business sense and marketing. After all, how better to set your prices than by judging the maximum that customers are willing to pay? The only tricky thing about value-based pricing is that any judgement is subjective. For example, I love the design and funky look of Apple's gear and will happily pay premium dollars for a new MacBook Air or the latest iPhone. My son Daniel, however, doesn't place much value on Apple's design and prefers generic products. Therefore, the value Daniel places on an iPhone is significantly less than the value I place on the same item.

Building a Hybrid-Pricing Plan

So far in this chapter, I talk about the theory of pricing and different pricing strategies. However, most successful businesses don't employ a single price strategy; instead, they employ a combination of strategies.

An example is a luxury inner-city hotel. Most of the time, they use competitive-based pricing, setting rates with the awareness of competitors' pricing very much in mind. However, with their premium rooms, they use value-based pricing, often improvising rates on the spot according to demand and what they think customers will be prepared to pay. Finally, for last-minute rates where they have a bunch of empty rooms and they know they won't be able to fill all of them, they use cost-based pricing, charging just enough above cost to make it worth their while to fill the room.

Using a combination of pricing strategies is called *hybrid pricing*, and is key to growing profitability in your business. The next part of this chapter explores ways to introduce hybrid pricing into your business, including premium products, no-frills products, package pricing and differential pricing.

Offering a premium

With hybrid pricing, offering a premium product or service is only part of the picture. The idea is that as well as offering a premium product or service, you also offer a regular product or service. In other words, you target more than one type of customer.

PRICING GOODS THAT YOU MANUFACTURE YOURSELF

If you're manufacturing goods yourself, you must differentiate between what you charge at wholesale versus what you charge at retail. Even if you currently don't sell your goods at wholesale — maybe you're selling your wares at market stalls or directly to retail outlets — for your business model to be sustainable you almost certainly have to consider wholesale pricing at some point.

Why? Most manufacturers who work on a small scale (and I'm kind of assuming you do, because if you're the general manager of Ford Motors, you're probably not reading this book) don't have enough of a range or a broad enough sales team to service a wide range of retail stores. Range is always an issue for smaller businesses, because most large retailers don't want to bother dealing directly with suppliers who only offer two or three products.

In addition, although you may be able to service retailers in your local area personally, chances are you won't be able to regularly visit retailers interstate or in regional areas. Servicing these retailers almost always involves selling the products you make to some kind of distributor or wholesaler.

The crunch in regards to your pricing will be that your wholesale price ends up being a relatively small percentage of the retail price. For example, a shopkeeper selling an item for $20 probably doesn't want to pay much more than $10 for that item. The wholesaler who receives $10 probably won't want to pay much more than $7. So out of a possible revenue of $20, you only receive $7, and out of that $7 you need to pay all the costs of production. This is fair, and reflects the reality of doing business and the costs of distribution, but can sometimes put a damper on what you may have been thinking is a great business idea.

Here are some examples:

- Amazon offers different pricing for freight, depending on how quickly you want your order delivered.
- My butcher sells two types of minced beef: Low-fat and not-so-low fat.

» The guy who mows our lawns offers two services: Regular just-with-a-lawn-mower mowing and premium all-grass-edges-trimmed-within-an-inch-of-their-life mowing.

REMEMBER

Offering a premium product doesn't necessarily mean you compromise on the quality of your other products (a strategy that could risk the reputation of your brand). You can structure premiums in many different ways, such as faster service, guaranteed response time, additional services and complimentary extras.

Cutting back the frills

The flipside of premium pricing (refer to the preceding section) is *no-frills pricing*. No-frills pricing doesn't necessarily mean inferior quality, but can include things such as off-peak pricing, lower service standards, longer response times or shipping times or limited availability. Here are some examples:

» Frequent-flyer programs place restrictions on what flights are available for frequent-flyer points.

» Many gyms offer low-cost membership if you attend outside peak periods.

» Tourism operators employ no-frills pricing for off-peak periods.

» Supermarkets offer generic brands with basic product packaging.

TRUE STORY

My husband's recording studio business offers a no-frills product on Mondays and Tuesdays (traditionally the quietest days of the week for bookings). Musicians can visit the studio for a fixed duration of eight hours to record and mix up to four tracks. John doesn't offer any flexibility with this model (you can only book on a Monday or Tuesday, you can't book fewer than eight hours, and you don't get to choose your engineer), but nonetheless these days are almost always booked out, because there are always musicians looking for a good deal. With this no-frills deal, John manages to attract customers he would normally miss out on with his regular pricing.

Getting creative with packages

Package pricing, where one product or service is bundled with something else, is another example of hybrid pricing. Package pricing can include bundling two or more products or services together, offering bonus products, and extended warranties.

Examples of package pricing include

- A day spa offering a pedicure, waxing and massage as a package.
- A tourism operator offering flights, accommodation and meals as a package.
- A club offering a free giveaway of some kind for every membership renewal.

AHEAD OF THE PACK

If you're just starting up a new business, you may be pushed to think of how you could offer package pricing. Keep thinking creatively. Keep in mind that your business doesn't need to provide all elements of the package and that often the best approach is to team up with another business.

Charging different prices for the same thing

Yet another pricing strategy — and one that sounds kinda dodgy at first — is to charge different prices for the same thing (this is also known as *differential pricing*). Don't worry — I'm not proposing you breach trade practice legislation. Instead, I'm talking about charging different prices depending on the quantity ordered, the total size of an order, the costs of shipping to customers, how promptly customers pay, how much the customer orders in the course of a year, and so on.

Differential pricing works really well for almost any business because it enables you to maintain your margins for regular sales, but generate extra income by selling to other customers at a discount.

You have so many ways to implement differential pricing that I'm going to spell out a few examples:

- **Pricing based on customer location:** Charging different rates (either for shipping or for on-site service) depending on where the customer is located makes good sense, although you still want to keep your pricing structure pretty simple.

- **Pricing based on loyalty:** Offering special pricing to customers who are members of your loyalty program or members of an affiliate organisation is a good marketing strategy and rewards customer loyalty.
- **Pricing based on order size or quantities ordered:** This kind of pricing makes intuitive sense straight off the bat. Almost any business will charge a different price for someone who buys 1,000 units rather than 10. (When you structure pricing according to quantity, this is called *quantity-break pricing*.)
- **Pricing based on payment terms:** Offering credit terms is expensive, not just in terms of using up working capital but also because of the risk of bad debt. Consider offering higher discounts for payment upfront or payment within 7 days.
- **Pricing based on total spending:** Providing reward incentives for total spending often features as part of loyalty programs and makes good business sense. For example, if customers spend more than $500 over the course of the year, they get something for free.
- **Pricing based on customer commitment:** Another clever strategy is to offer discount pricing but make the customer jump through hoops to get it. Money-back coupons where you have to post proof of purchase to the supplier or price-match guarantees are examples of this kind of pricing.

Forming a Plan of Attack

Earlier in this chapter, I talk about a whole load of pricing strategies. Thinking about possible pricing strategies in this way may help spark some new ideas and creative thinking in how you approach pricing your products or services for profitability. However, you may also be feeling a little overwhelmed and wondering where to start. So here's my specific recommendation for the process to follow:

1. **Do some research as to what you think customers will be prepared to pay.**

   This research will involve looking at what competitors are charging as well as thinking about how your product or service is different and what value customers are likely to place on this difference.

2. **Think about how you could vary your product or service to provide two or three 'levels' of pricing (no-frills, regular and premium).**

   Not every business can offer multi-level pricing (for example, I don't know that I'd seek out a surgeon offering a no-frills service), but you'd be surprised how many types of businesses can. (Refer to the section 'Building a Hybrid-Pricing Plan', earlier in this chapter, for more on pricing levels.)

3. **Investigate at least two ways to bundle or package your offering with other products or services.**

   'Getting creative with packages', earlier in this chapter, provides a few ideas on this topic.

4. **Find two or three ways to charge your customers different prices for the same things.**

   This pricing strategy (differential pricing) is probably the most crucial of all. Even if you can't figure out how to have more than one level of pricing, or you can't come up with a method to create a package, you should be able to incorporate some form of differential pricing in your strategy. 'Charging different prices for the same thing', earlier in this chapter, provides some pointers as to how you can do this.

REMEMBER

Although the upside of a hybrid-pricing strategy is that you maximise the number of customers you can reach, and hopefully make premium profits on at least some of your sales, you can risk confusing customers if you offer too many options. As your business grows and changes, experiment with different pricing combinations to see what works best and gets the best response from your customers.

Monitoring and Changing Your Price

If you've already been in business for a while, you may feel that your price strategies are pretty well settled and working just fine. That's good, but regardless of whether you're just starting out in business or you're running a 50-year-old family legacy, you still want to keep an eye on your pricing.

The biggest indication that your pricing may need to shift is if you have poor profitability. Of course, poor profitability can be caused by many factors, not just pricing. However, if you know that your competitors have just raised their prices, your customers are commenting what good value you are, or you haven't raised your price in more than a year or two, it's probably time to do a price review.

REMEMBER

Changing prices doesn't only mean raising prices. Always be open to new pricing plans, special offers, package pricing and so on. If you do decide to raise prices, try to do so incrementally and avoid big price hikes that may scare your customers. Alternatively, find ways to sneak price rises through the back door, such as only increasing prices on certain low-profile products or services, or getting rid of discounts.

DISCOUNT DRAMAS

If you build discounts into your pricing strategies, be careful that when you offer discounts, your business receives something tangible in return. For example, offering a discount for cash payments rather than credit card payments makes sense because you normally pay merchant fees on credit card transactions. Similarly, offering a discount for prompt payment probably makes sense (depending on how much discount you offer) if you're currently in debt to the bank and paying interest.

Another example is if you discount overstocked or end-of-season items. This makes sense because these slow-moving items are taking up valuable shop or warehouse space that could be better used for product that actually sells.

However, if you routinely offer discounts without receiving something that benefits your business in return, you risk eroding your profitability model. In addition, regular customers may get used to these discounts and come to expect them.

IN THIS CHAPTER

» Balancing reality with ambition for a new business

» Realising the limits of your superhuman powers

» Finding different ways to increase sales and set new targets

» Supporting sales targets with strategies that work

Chapter 6
Setting Sales Targets With Profit in Mind

In this chapter, I talk about setting sales targets for your business. Perhaps you're just starting a new business, and unsure how to create any kind of sales forecast when the future is so unknown. Or perhaps your business is quite established, and you want to set sales targets that are simultaneously ambitious (you want to stay motivated, after all!) but also realistic. I cover all these options in this chapter.

I also touch on some of the marketing strategies necessary to support your sales targets. While my exploration of this topic is relatively brief, the key point is that you can't set sales targets without deciding what marketing activities you'll put in place as support for these targets.

Forecasting Sales for a New Business

If your business is still getting established, setting sales targets can be really hard. Maybe people are going to flood through the door, maybe you're going to be a ten-week wonder, or maybe your business will grow steadily and organically over time. However, in order to build a plan for profit, you need to start with some kind of sales forecast.

Adopting an expansionary mindset

When you're getting started in business, I encourage you to think broadly. Picture what your business could be in five or ten years' time, and the markets you might be able to reach. Then scale back mentally and start planning your sales targets for the immediate future, but with these bigger plans in mind.

One trick to this kind of thinking is to incorporate a high level of detail. Try to slice up sales targets by *market segment*, *product*, *region* and *price-level*:

- **Market segment targets:** *Market segment* is a fancy term that really means type of customer or type of work. For example, a building contractor may split his market into new houses and renovations, a musician may split her market into weddings, private functions and pub gigs, and a handyman may split his market into private clients and real estate agents. What market segments could you try to reach, and which ones do you think might be most profitable for you in the long term?
- **Product-based or service-based targets:** With product-based targets, look at every item you sell, and try to set targets according to units or dollars sold of each one. For example, a car yard could aim to sell at least 20 cars a month or a real estate agent could try to sell five houses every month.

  With service-based businesses, set targets for each 'unit of service' delivered. For example, a lawn mowing business could set sales targets of 80 lawns per month, or a party planning business could set targets of five parties per week.
- **Regional targets:** With regions, you set sales targets according to geographic regions. This works best for slightly larger businesses that typically have a dedicated salesperson or sales team in each region.
- **Price-level targets:** In Chapter 5, I talk about creating different pricing levels or packages for your business. You may want to incorporate targets for each pricing level within your business.

Once you've figured out how you want to slice your sales targets, the next step is to create weekly or monthly sales forecasts that include this level of detail. Table 6-1 shows a few examples of how you might forecast sales for each item or service you sell, and include average sales price and the number of units sold per week.

TABLE 6-1 **Incorporating detail (and a healthy dose of ambition) into your sales forecasts**

	Unit Price	Units Sold	Sales per Week
Cakes to Cafes Business			
Friands	$2.00	100	$200.00
Muffins — regular	$1.50	100	$150.00
Muffins — wholesale	$1.30	50	$65.00
Chocolate brownies	$2.20	130	$286.00
Teacakes	$7.00	60	$420.00
Total			**$1,121.00**
Naturopath			
Short consultation	$65.00	20	$1,300.00
Long consultation	$130.00	5	$650.00
Consult + massage	$200.00	2	$400.00
Herbs	$45.00	15	$675.00
Phone consultation	$50.00	3	$150.00
Total			**$3,175.00**
Retail fashion			
Clothing $11 to $20	$15.00	88	$1,320.00
Clothing $21 to $30	$25.00	32	$800.00
Clothing $31 to 40	$35.00	48	$1,680.00
Clothing $41 to 50	$45.00	30	$1,350.00
Clothing $51 to $60	$55.00	18	$990.00
Clothing $61 to $70	$65.00	6	$390.00
Total			**$6,530.00**

Balancing reality against ambition

As I mention in the previous section, when you create a sales projection or marketing plan, you want to include a decent level of detail regarding the number of units sold, number of products sold, sales by region or sales by market segment. You should also include short descriptions explaining how you arrived at these figures. The idea is that your forecast or plan generates a sense of confidence in whoever reads it — even if this audience is just you.

However, while you want your targets to be inspirational — after all, this book is about encouraging your entrepreneurial bent and seeking extra profits — you also want to ensure your targets are both achievable and realistic.

For this reason, you may want to develop two versions of your sales targets:

- The first version of your sales targets should be relatively conservative in its sales estimates, and should correspond to your overall financial projections. Such caution is important when growing a business, because you don't want to end up overspending should sales not be as high as you had hoped. This first version forms the 'real' budgets that you know must be met in order to keep hunger at bay.
- The second version of your sales targets includes a decent amount of s-t-r-e-t-c-h, with total sales perhaps a good 20 per cent higher than the first version, and forms the basis of your sales targets. This highly specific budget expresses targets in terms of units sold, sales to each region or number of services delivered.

AHEAD OF THE PACK

While running two sets of targets may sound duplicitous, this method acknowledges the importance of balancing financial conservatism against the need to inspire entrepreneurialism and creative drive.

Forecasting Sales for a Service Business

In the big picture, hiring employees is the only way a service business can generate significant profits. With employees delivering the service, your business isn't exclusively reliant upon you, and you can be earning money while snoozing on the sofa or fishing down the coast.

WARNING

Even though employees are needed to grow profits, if you're new to the game and you're not ready to hire employees, I suggest you start by estimating how many hours you can realistically charge per week, per month or per year. It's easy to overestimate the number of hours you can bill customers for, and hence end up overestimating the profit you're likely to make.

Checking how many hours you're likely to bill

Imagine a recent uni graduate (I'll call her Maddie) wants to set up a business as a maths tutor. Maddie reckons she can teach about 48 students a week (and if each lesson is 30 minutes, that's 24 hours of teaching), and that she's going to charge $60 per hour. With this in mind, she reckons that she'll earn $74,880 per year. (That's 24 multiplied by 52 weeks multiplied by $60.)

Is Maddie correct in her estimate of income for the next 12 months? I'm going to test her calculations using the following step-by-step method, which you can use as well:

1. **Estimate how many days you're going to work each week, and how many hours you can realistically charge for each day to arrive at your average number of billable hours per week.**

   When doing this calculation, remember to include billable hours only. Don't include travel time between locations, non-billable time due to administration/paperwork, or time spent running your business (bookkeeping, customer phone calls, marketing and so on).

2. **Estimate how much holiday you're going to take (or be forced to take) each year.**

   Here, don't only think in terms of lying on the beach watching the surf, but include both holidays where you go away and breaks where you may be available to work, but you can't. (For example, a school tutor probably won't get much work in school holidays, a gardener may find it hard to work in heavy rain or snow, or a business consultant may find that work grinds to a halt the month before and after Christmas.)

In Table 6-2, I've included 12 weeks against the holiday time Maddie will take annually, because that's the number of weeks of school holidays each year.

3. **Make an allowance for public holidays.**

   Most people don't work public holidays. If you don't plan to (or maybe you can't because your customers will be unavailable), you have to allow for public holidays as well. Public holidays of ten days a year equate to an equivalent of two weeks per year. In Maddie's case, many public holidays also coincide with school holidays, so I've only allowed for one week's worth of public holidays per year.

4. **Think of what will happen if you get sick.**

   My observation is that being a freelancer (or sole trader) is one of the best possible ways of ensuring good health. Knowing that you won't get paid if you don't show up is a real incentive to getting out the door, however you're feeling. However, most people do get sick from time to time, and it's realistic to make an allowance for this. For Maddie, I've allowed another one week's worth of sick days per year.

5. **Calculate how many weeks per year you will be able to charge for.**

   In Maddie's case (see Table 6-2), after taking out holidays, public holidays and sick days, she can likely work a full week (that's 24 billable hours) for only 38 weeks of the year. (Most businesses that aren't dependent on school terms can probably work more weeks per year than this, however.)

6. **Multiply the number of working weeks per year by the number of weekly billable hours, to arrive at your maximum billable hours per year.**

   As shown in Table 6-2, for Maddie this equals 38 weeks per year multiplied by 24 hours per week, making a total of 912 hours.

7. **Multiply your maximum billable hours per year by your hourly rate.**

   The result for Maddie is $54,720 per year, quite different from her initial estimate of $74,880.

   Note: Remember that this method shows you the *maximum* billable hours per year. If you're still getting your business established, it may be some time before you can build your business up to this point.

TABLE 6-2 Calculating Maximum Billable Hours per Year

Number of days per week	5
Average number of billable hours per day	4.8
Total billable hours per week	***24***
Number of holiday weeks per year	12
Number of public holidays per year, expressed in weeks	1
Number of sick days per year, expressed in weeks	1
Total working weeks per year	38
Maximum possible billable hours per year	**912**
Hourly rate	$60
Maximum possible income per year	***$54,720***

TIP

Depending on the kind of service business you own, do consider whether you might generate more profits by charging a fixed fee, rather than charging by the hour. Bookkeeping businesses, property maintenance businesses and cleaning services are just three examples where fixed fee models provide an extra marketing edge, and typically generate additional profits.

Increasing profit with extra labour

As I mention earlier, the key to building profit for a service business is to hire employees who can deliver services to your customers (rather than you doing all the work yourself). For example, don't just think of how many lawns you can mow, kids you can tutor or companies you can consult to. Instead, picture a team of people mowing lawns, a whole school of tutors or an entire posse of consultants.

AHEAD OF THE PACK

If your business is labour based, leveraging your expertise in this way is the only possible method by which you can hope to earn more than the industry average. For example, if you start up a business as a gardener, a maths tutor or a physiotherapist, you can only work so many hours in the week (as I explain in the previous section of this chapter). However, with a team of employees working for you, all delivering this service, you may be able to make a decent profit.

I suggest you create a couple of sales projections so you can analyse the impact of hiring new employees. In Figure 6-1, I separate the services that the owner plans to provide herself, and services that she plans to use employee or subcontract labour for. I do this because the costs of labour are so different. For example, the owner of the party business does the entertainment at many of the kids' parties herself, and for each of these parties she earns at least $170. However, if she pays for someone else to go to the party, she only earns $50.

Separating out services in this way, analysing what services you could provide and what services you plan to use employees or subcontractors for, is a great approach for seeing how you can expand sales in your business. And having services separated also helps when you get to adding costs (such as the cost of labour) into your profit projections (a topic I cover in the next chapter).

	A	B	C	D	E	F	G
1		**Price**					
2	1 hour 30 Package	$ 170.00					
3	2 hour Package	$ 190.00					
4	2 hour Plus Package	$ 210.00					
5							
6		**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
7	**Parties with owner's labour**						
8	1 hour 30 Package	12	12	12	12	12	12
9	2 hour Package	4	4	4	4	4	4
10	2 hour Plus Package	1	1	1	1	1	1
11							
12	**Parties with subcontract labour**						
13	1 hour 30 Package	8	12	13	8	12	80
14	2 hour Package	7	6	8	10	12	18
15	2 hour Plus Package	1	3	4	4	5	8
16							
17	**Income Generated**						
18	1 hour 30 Package	$ 3,400	$ 4,080	$ 4,250	$ 3,400	$ 4,080	$ 15,640
19	2 hour Package	$ 2,090	$ 1,900	$ 2,280	$ 2,660	$ 3,040	$ 4,180
20	2 hour Plus Package	$ 420	$ 840	$ 1,050	$ 1,050	$ 1,260	$ 1,890
21	Total Sales	$ 5,910	$ 6,820	$ 7,580	$ 7,110	$ 8,380	$ 21,710

FIGURE 6-1: Building a sales forecast in Excel for a service business.

Pushing Targets for an Established Business

If you've been running your business for a while, you may be tempted to generate sales forecasts simply by analysing what sales have been for the last 12 months, and then extrapolating from there. While historical sales results are always going to provide you with a strong indicator for future sales, I do suggest that you experiment a little to see how different sales strategies could increase your potential turnover.

Playing the percentage game

When experimenting with sales projections, I suggest you try tweaking your prices by a small percentage wherever you can. Look at monthly and yearly sales totals to test the impact this change has on your turnover and profitability.

Here are some examples:

- I knew a book distributor who increased all prices by four cents each (the price of a book became $12.99 rather than $12.95, $24.99 rather than $24.95, and so on). A tiny difference that the bookstores didn't care about, but one that generated a neat $18,000 extra profit per year.
- Petrol stations, where the turnover is huge but profit margins slim, can make an enormous difference to profitability by varying prices by just 1 per cent, or even less.
- A tyre retailer who I worked with was continually struggling with profitability. When we analysed their pricing, we discovered just a few brands of tyres where price was crucial in order to appear competitive. With this in mind, they bumped up the price of all the other tyres by a modest 5 per cent. The tyre prices weren't affected much (a $150 tyre now cost $157.50), but 5 per cent on an annual turnover of $1,000,000 in this product segment meant $50,000 extra profit per year.

In any kind of business, identify the price-sensitive products or services (such as milk and bread in a general store). Keep these prices low. Then identify the products that aren't price sensitive (maybe gourmet goat cheese in a general store) and aim for handsome profits on these items. For more about pricing, refer to Chapter 5.

Focusing on the profit

When setting sales targets, be careful not to focus exclusively on turnover. Instead, let your focus be on ways that you can increase your profits, and take time to understand the profit margins on the different income streams flowing into your business.

MONEY STUFF

This process of analysing the profits generated by each department of a business is usually referred to as *cost centre analysis*. (You can usually configure your accounting software to report on different cost centres using job reporting, category analysis or class analysis features.)

Here are some examples of businesses which have different cost centres:

- A tradie who does repairs and maintenance but also mows lawns
- A hairdresser with three different shops in three different suburbs
- A distributor that sells goods both online and at wholesale
- A retailer with products that fall into a handful of different departments
- A wholesaler who sells imported goods but also manufactures goods to sell

Of course, even if you can report on the profits generated by each cost centre in your business, you must be prepared to act on this information. For example, maybe you operate from three locations but you know that one location is always running at a loss. Perhaps the best decision is to close this location, even if this means accepting that you'll never recoup your losses on this venture, and you'll reduce your turnover.

Conversely, perhaps reports show that a particular product or service is always super profitable. Take a moment to consider whether you can find new opportunities here, and whether you should switch your strategic focus.

WARNING

At times in my life, I've been utterly consumed with the day-to-day demands of my business, working flat chat just delivering services to clients and meeting deadlines. I often feel as if I'm a hamster on a wheel, peddling at my physical limit just to keep going. In times such as these, I find it quite hard to take a step back and look at what's working in my business, despite knowing that it's the capacity to work *on* my business, rather than *in* my business, which will enable me to realise its full potential. If you can, try to guard against this kind of situation, and build in regular time for business planning and reflection.

Defining targets differently

I sometimes like to set sales targets that aren't just expressed in dollars or units sold, but in other attributes as well. You may want to express sales targets in terms of expanding geographic reach, converting more enquiries to sales, increasing your repeat business, increasing customer satisfaction, or many other things besides.

In Table 6-3, I list a few examples of sales targets that aren't measured in dollars. In the first column, I list long-term targets; in the second column, I list short-term targets; and in the third column, I list the strategies the business intends to employ in order to support these targets.

Non-financial targets vary hugely from one business to another, but the important thing is that you think of what targets might be relevant for you, and how you might measure your performance against these.

TABLE 6-3 **Different kinds of sales targets**

Long-Term Target	Sales Target for the Quarter	How to Support this Target
Acquire new customers who have similar values and priorities to us	Acquire at least one new 'ideal customer' each month	Redesign our branding and marketing campaign to reflect the core values of our business more strongly
Increase online sales to be at least 50 per cent of turnover	Grow online sales by 5 per cent	Targeted social media advertising; refresh website; expand blog and online presence
Improve booking rates from enquiries	For every 25 quote requests, aim for 10 sales	Automate email responses for quick replies; engage copywriter to review landing page and email templates
Increase repeat business	Repeat business to be 35 per cent of total sales	Review email campaigns for subscriber lists; create monthly special offers; survey customers after each sale to measure satisfaction
Increase customer satisfaction ratings	For all customers who respond to surveys, over 90 per cent say that they would buy from us again	Review of product quality control; implement 24-hour order turnaround

Making Targets Work

For every sales target you set, you need to implement marketing strategies that support these targets. Some marketing strategies can't be matched to specific targets (for example, building up brand recognition is something that supports all sales targets), but other strategies can (for example, social media advertising restricted to a specific location is a marketing strategy that supports a sales goal to increase local business).

The scope of this book isn't enough to go into the details of creating a marketing plan (for more info on this topic, check out *Small Business For Dummies*, 6th edition, written by yours truly). However, I would strongly encourage you to develop a detailed marketing plan that supports all the sales targets that you set and, indeed, serves to promote the overall identity, strategy and profitability of your business.

Nonetheless, in the last section of this chapter, I touch very briefly on three key elements of marketing: Growing your brand, creating a social media strategy, and building trust with your customers.

Growing a brand that people want

Brand marketing is very different from direct or transactional marketing. With brand marketing, you're trying to change how customers perceive your company or product, as opposed to trying to make a sale.

Businesses tend to have two types of image:

- Business image (sometimes also called *corporate branding*)
- The image of the things they sell (sometimes called *product branding*)

Think of your business as having its own identity, personality and image, and ensure that this identity closely reflects your business strategy. This image is made up of lots of things, but includes your name and logo, marketing taglines, the design ethos of your marketing collateral, your company dress code, the quality of your products or services, the style of your communications and the general culture of your company.

AHEAD OF THE PACK

Branding is one of the most important elements in your marketing strategy. For this reason, I recommend you avoid doing things on the cheap when choosing a business name, getting a logo designed or developing marketing materials. It takes years of experience and training to develop an eye for design, shape, proportion and colour, as well as a high level of skill to understand how these elements interact with your business strategy and vision.

TRUE STORY

Don't dismiss the concept of branding as only being relevant to big corporates. For example, I have a friend who inherited his father's plumbing business. The business was low-key, run from home with an old, battered van, little advertising and no employees. My friend transformed the whole image of his father's business, modifying the name, leasing a new vehicle, advertising online, employing new staff and radically improving customer service standards. All of these actions were part of my friend creating a very successful brand for this small but growing business.

TIP

Franchises are typically very good at delivering a clear image and a strong brand. If you know of a franchise group that operates in the same kind of business as yourself, have a close look at what they do and how effective their brand marketing is. For example, if you're thinking of starting a cleaning service, check out the image of a couple of successful cleaning franchises. (You, too, can have a snazzy pink and blue uniform.)

Finally, do ensure your brand has adequate legal protection, so that another company isn't able to use your company name, product names or even taglines. (Go to `business.gov.au` for more information on registering your business name and trademarks.)

Defining your social media strategy

I understand that whole books are devoted to the topic of social media strategy and, even then, may be insufficient to provide all the information you need. So, in the interests of staying relevant but concise, I'm going to share five quick tips regarding supporting your sales targets using social media:

- **Don't pretend social media isn't a thing:** If your business doesn't already have a presence on at least one social media channel (Facebook, Instagram, LinkedIn, Messenger, Pinterest, Tumblr, Twitter, WeChat and YouTube are all examples of channels that are strong tools for business), then you need to get started now. A business without a social media strategy isn't a thing.

- **Understand that each channel serves a different purpose and target market:** If you're selling fashion, Facebook is going to work better than LinkedIn; if you're a high-end consultant, LinkedIn works better than Pinterest. If you don't understand the differences between the main social media channels, and why one might serve your business better than another, seek advice from a marketing expert. Don't just leap into using the channel with which you're most familiar.

AHEAD OF THE PACK

- **Be clear about whether your posts are aimed to build engagement or generate sales:** Social media is ideal for generating conversations with customers, building loyalty and attracting followers, and this customer engagement is an essential precursor to securing sales. Most businesses find that they need to create a mix of posts that engage customers with news and interesting information, and are designed to make a sale. You need to be clear about the difference between these kinds of posts, and what you're trying to achieve with each one.
- **Narrow your market, and then narrow again:** Social media is not about mass marketing; rather, it's about defining your market in a super specific manner and then creating messaging designed specifically for this audience. Spend time narrowing down your market, defining the audience likely to view your posts, and tailoring your messaging.
- **If you're not really good at this whole game, pay for help:** One of the traps with social media is that everybody thinks they are an expert. However, speak to professionals immersed in this industry, and you quickly realise that doing social media well requires a great deal of knowledge, time and creative flair.

Engaging customers and building trust

I'm updating this book in the middle of the COVID-19 pandemic (well, hopefully the middle, not the beginning!). One of the struggles many businesses have had during this time is how to maintain their relationships with customers, especially if they've been forced to close down. Right at the beginning of the first lockdown, a marketing consultant advised me that I shouldn't aim to make profits during this period, but rather I should find ways to stay relevant to my customers at a time when they might need my support.

TRUE STORY

At first, I couldn't quite picture how to put this advice to stay relevant into practice, but I've seen many examples over the past few months. A local restaurant, forced to temporarily close, shared on social media that it was now making meals for homeless people, and invited customers to drop off donations of ingredients. The staff in a beachside resort, which was again forced to close, posted daily whale-watching reports and videos. At the writers' residency where I work, we offered free online daily writing sessions to our writing community, who weren't able to travel to Katoomba (in the Blue Mountains in New South Wales) during lockdown.

Each of these examples shows ways that businesses can engage with customers, even in the most fraught of circumstances. In short, customer engagement is less about making sales, and more about building and maintaining trust.

Here are my top tips for engaging with customers:

- **Ask questions:** People love to be asked things, whether it's a quiz, a poll, a chance to test their knowledge, or a chance to share their expertise.
- **Ask for reviews:** If you have an ecommerce site, build in the facility where customers can post their reviews. Not only do you receive timely feedback about your products, but you also provide your customers with an opportunity to have their say.
- **Be authentic:** The quality of authenticity is often what strikes me first. I'm quick to sense whether the person helping me believes in what they're doing and genuinely wants to assist. Of course, a sense of humour doesn't go astray either, especially when it comes to complex or time-consuming interactions.
- **Be consistent:** For me to grow trust in a brand or a business, I need to experience a high level of consistency. Even though I recognise the challenges of delivering great service every single time, particularly for relatively new companies with a small number of employees, I know that it only takes one or two poor experiences to erode my confidence.

- **Create clubs or memberships:** You know the kind of thing — a loyalty club with monthly special offers, or a membership offering exclusive benefits.
- **Involve your customers:** Find ways to make your customers feel that they are part of your company, and that they have a say in what you do.
- **Offer things for free:** Find ways to recognise loyal customers. (Giving away services or products for free doesn't have to cost you money, depending on how you organise such offers.)
- **Run competitions:** Most folk love a chance to win, and you can have great fun with competitions — whether it's asking customers to write their own flash fiction murder mysteries in order to win a weekend pass to a writers' festival, or offering a weekend away to the first customer who successfully solves a complex riddle.

REMEMBER

- **Share information that's useful or news that captivates:** A solar panel business might share info about cleaning your panels after a dust storm, for example, or a tutoring business might share tips about managing your child's anxiety before exams.

Finally, don't forget that in the ideal world, customer engagement is about sharing your love of what you do, and having a bit of fun along the way.

IN THIS CHAPTER

» Working out the costs for every sale you make

» Creating a 12-month forecast for business expenses

» Pulling it all together to reveal your bottom line

» Understanding the nature of the beast

» Keeping the hungry wolf at bay

Chapter 7 Modelling Business Scenarios

Any small business needs profit projections to map the way forward. If you're starting a new venture, financial projections help calculate how much capital you require, and assess the profitability of your proposed business model. If you're an established business, profit projections guide decisions about growth and change.

This chapter helps build your financial literacy, explaining how to bring the elements of income, costs and expenses together in order to predict profitability one, three or even five years ahead. This chapter also talks about the importance of managing your personal expenses, particularly for new business owners who may be struggling in the absence of benevolent fairy godmothers.

Understanding Cost of Sales

In order to manage the financials of your small business effectively, you first need to grasp the difference between variable costs and fixed expenses. *Variable costs* (also sometimes called *direct costs* or *cost of goods sold*) are the costs that go up and down in direct relation to your sales.

Keep the following in mind when considering variable versus direct costs:

- If you're a service business, you may not have any variable costs, but possible variable costs include sales commissions, booking fees, equipment rental, guest consumables or employee/subcontract labour.
- If you're a retailer, your main variable cost is the costs of the goods you buy to resell to customers. Other variable costs, particularly for online retailers, may include packaging and postage.
- If you're a manufacturer, variable costs are the materials you use in order to make things, such as raw materials and production labour. (Think of the neighbourhood kids making lemonade — their variable costs would be lemons and sugar, and perhaps cups.)

Fixed expenses (also sometimes called *indirect costs* or *overheads*) are expenses that stay constant, regardless of whether your sales go up and down. Typical fixed expenses for your business may include accounting fees, bank fees, electricity, insurance, motor vehicles, rental, software subscriptions and wages. I talk more about fixed expenses later in this chapter, in 'Forecasting monthly expenses'.

Costing your service

I mention in the preceding list that if you're providing a service, you may not have any variable costs associated with your business. However, you may well have some minor costs associated with providing your service and, as soon as your business grows, you will have the cost of hiring employees or contractors to provide the service on behalf of your business.

Table 7-1 shows some examples where variable costs apply for service businesses.

TABLE 7-1 Variable Costs Examples for Service Businesses

Type of Business	Likely Variable Costs
Contract cleaning	Cleaning staff wages, cleaning materials
Holiday house	Guest consumables, booking commissions
Massage therapist	Daily room hire
Home maintenance business	Building materials, cost of subcontractors
Medical practitioner	Medical supplies, pathology

REMEMBER

If you're unsure whether something is a variable cost or a fixed expense, ask yourself this: Do you spend more on this item as sales increase? If your answer is yes, chances are this item is a variable cost.

Costing items that you buy and sell

When calculating costs for items that you buy and then sell, you have two types of costs to consider:

- **Incoming costs:** These are the costs involved in getting the goods to your door. Incoming costs usually include freight and, for importers, may also include customs charges, duties and tax. Incoming costs may also vary significantly depending on the quantity you order.
- **Outgoing costs:** These are the costs involved in making the sale and getting the goods to your customer. Outgoing costs include sales commissions, discounts, outwards freight, packaging and storage.

WARNING

If you decide to import goods from overseas, doing your product costings carefully is particularly important. Even if current exchange rates make your prices look cheap as chips, this rosy picture may soon fade when you add the costs of freight, customs, distribution and taxes, which can easily add a further 40 to 50 per cent to the cost of a product.

REMEMBER

If you're restricted to buying and selling in different currencies — maybe you buy in US dollars but sell in Euros — take the time to generate multiple pricing models and make sure you can still be profitable even if the exchange rate changes substantially.

THE DANGERS OF CUSTOM MANUFACTURE

REMEMBER

Over the years, I've observed that almost any business doing custom manufacture struggles to make a profit. Why? The very nature of creating one-off pieces — whether these are original sculptures, handmade furniture, custom spiral staircases or hand-built guitars — means that you are engaging with the unknown.

The unknown factor may be materials that cost more than you expect, a customer who isn't happy with the first prototype, underestimating the cost of labour, or many other factors. The time taken up discussing a job with a customer, drawing up designs, communicating changes and working out how to do something is almost always more than you expect.

When you create one-off items, you don't have the same ability to control your costs in the way that you do when you make the same item over and over again.

Am I warning you never to engage in this kind of business? No, not quite. After all, without custom manufacturers our society would be without potters and artists, sculptures and artisans, furniture makers and craftspeople. However, if you're planning this kind of business and you want to make a profit, you will need to be particularly brutal about quotations and costings, and you need to be prepared to reject jobs where the margins are too slight.

Costing items that you make

A recent summer stretched into weeks of long, sunny days. The next-door kids, Callum and Rhys, hatched a plot to make homemade lemonade and sell it to thirsty passers-by. Most days I'd stop and buy a glass and the kids would happily announce how much profit they'd made so far. The holidays were almost at a close the afternoon I bumped into their mother in the supermarket. She had a trolley piled high with lemons. 'This profit the boys are making is costing me a fortune,' she laughed.

Chances are that such halcyon days belong only to childhood and that, in your business, you're going to have to be seriously realistic about what everything costs. No more lemons for free.

I suggest that if you manufacture products, you start by creating an accurate costing worksheet for each product that you sell. Table 7-2 shows a possible product costing and the kind of information to include.

TABLE 7-2 Cost of Producing One Bottle of Pickle

Item	$	Notes
100 g fresh tomato	$0.80	Based on seasonal average
30 g onion	$0.05	
20 g sugar	$0.03	Based on buying in bulk 50kg bags
5 g salt	$0.01	Based on buying in bulk 10kg bags
Cost of labour	$0.88	Average 400 bottles per day, with labour $350 per day
Kitchen rental	$0.38	Average 400 bottles per day, with rental $150 per day
Bottle plus lid	$0.45	
Label	$0.35	
Packaging	$0.40	$3.20 per custom box, 8 bottles per box
Total	**$3.34**	

REMEMBER

Can you see how the example in Table 7-2 puts a value on labour? You may think this doesn't apply to you, because chances are if you're just starting out in business, you're contributing your own labour for free. However, when creating a product costing, you're best to include a realistic allowance for how much the labour would cost if you were to pay for someone else to create the product. This way, you can see the 'true' profitability of each product, and you get a better sense of the long-term potential of your enterprise.

The other interesting thing to consider is volume discounts. For example, in the product shown in Table 7-2, the cost of sugar is based on buying 50 kilograms at a time. However, how much would this business save if the owner was able to buy 100 kilograms at a time? (Even if your business can't afford to buy in large quantities yet, just knowing that your costs may reduce dramatically as your business grows is an important part of understanding your profit-making potential.)

Forecasting Expenses

When planning for business expenses, always separate start-up expenses from operating expenses:

- *Start-up expenses* are one-off expenses that you encounter when you first start a business, such as new equipment, company formation expenses, legal expenses and signage. I talk lots about start-up expenses in Chapter 4.
- *Operating expenses* are the kind of expenses that occur year in and year out, and which form a regular part of everyday trading. Operating expenses are the focus of the next part of this chapter.

Forecasting monthly expenses

If you've been running your business for a while, you already have a good idea of what your expenses are going to be. However, if you're just getting started with your business, thinking of the types of expenses you may encounter can be tricky. Are you going to take out insurance? What about accounting fees? Will you need to pay any professional memberships? What expenses could you face that you haven't even thought of yet?

Figure 7-1 shows a Business Expenses worksheet that lists expenses in the first column, how often they occur in the second column, an estimate of the amount in the third, and a calculated monthly total in the fourth.

	A	B	C	D
1	**Type of Expense**	**Frequency**	**Estimate**	**Monthly total**
2	Accounting Fees	Annually	$1,500	$125
3	Advertising	Monthly	$1,200	$1,200
4	Bank Charges	Monthly	$100	$100
5	Cleaning Expenses	Weekly	$50	$217
6	Computer Consumables	Monthly	$150	$150
7	Consultant Expenses	Monthly	$300	$300
8	Couriers	Monthly	$80	$80
9	Customer Consumables	Monthly	$60	$60
10	Electricity	Quaterly	$500	$167
11	Equipment Rental	Monthly	$200	$200
12	Freight Fees	Monthly	$300	$300
13	Gas	Quaterly	$300	$100
14	Hire Purchase Payments	Monthly	$650	$650
15	Insurance	Annually	$3,000	$250
16	Interest Expense	Monthly	$520	$520
17	Internet Fees	Monthly	$150	$150
18	Lease Expenses	Monthly	$800	$800
19	License Fees	Annually	$1,200	$100
20	Merchant Fees	Monthly	$320	$320
21	Motor Vehicle rego & insurance	Annually	$1,500	$125
22	Motor Vehicle Fuel	Weekly	$80	$347
23	Motor Vehicle Repairs & Maint	Annually	$2,000	$167
24	Motor Vehicle Tolls	Weekly	$70	$303
25	Office Supplies	Monthly	$150	$150
26	Parking	Weekly	$35	$152
27	Professional Memberships	Annually	$1,800	$150
28	Rates	Quaterly	$400	$133
29	Rental Expense	Fortnightly	$1,500	$3,250
30	Repairs and Maintenance	Annually	$6,000	$500
31	Replacements	Annually	$3,000	$250
32	Security Expenses	Monthly	$120	$120
33	Staff Amenities	Monthly	$300	$300
34	Storage Expenses	Monthly	$150	$150
35	Subcontractor Expenses	Monthly	$520	$520
36	Subscription and Dues	Annually	$2,200	$183
37	Telephone (inc mobile)	Monthly	$550	$550
38	Travel Domestic	Monthly	$350	$350
39	Travel Overseas	Annually	$3,500	$292
40	Wages and Salaries	Weekly	$3,500	$15,167
41	Wages oncosts	Weekly	$350	$1,517
42	Website expenses	Monthly	$850	$850
43	**Total Expenses**			**$29,672**

FIGURE 7-1: Start by estimating an amount for each expense, along with how often it occurs.

Here are some tips for how you might create a similar worksheet to forecast expenses for your own business:

- Most business forecasts are calculated on a monthly basis and, for this reason, be careful when converting weekly expenses into monthly expenses. To calculate a monthly budget for something you pay weekly, you need to first multiply the weekly amount by 52, and then divide it by 12 (rather than simply multiplying the weekly amount by 4). In this example, $300 a week rent multiplied by 52 equals $15,600. Divide this by 12 and you get $1,300 a month (not $1,200).
- If your business is already trading, the best way to make estimates is to look at what you've spent in the past. Old supplier invoices, accounting software transaction journals and monthly Profit & Loss Statements are all good sources for this information.
- Always keep variable costs (costs of purchasing goods for resale, or costs of production) separate from expenses. (See later in this chapter for how to create financial projections, and where the different elements of income, variable costs and expenses belong.)

One more thing. If you're registered for GST, don't include GST in the budgets for any of your expenses. Instead, show the value of each expense before GST is applied. (Why? Because GST applies only to the final sale to the consumer — as a business, you're entitled to claim back any GST that you pay.)

Forecasting expenses for the year ahead

In Figure 7-2, I show an example of a 6-month expense projection for a relatively small business. I've used a spreadsheet, but the principle is pretty much the same whatever tool you use. You can see the months running along the top, the names of the expenses down the first column, and an estimate of how much each expense will be along each row. I only show six months in this example (the page in this book is after all quite narrow!) but, mostly, expense worksheets project forward at least 12 months.

Type of Expense	Freqency	Estimate	Monthly total	Jan	Feb	Mar	Apr
Accounting Fees	Annually	$1,500	$125				
Advertising	Monthly	$1,200	$1,200	$1,200	$1,200	$1,200	$1,200
Bank Charges	Monthly	$100	$100	$100	$100	$100	$100
Computer Consumables	Monthly	$150	$150	$150	$150	$150	$150
Consultant Expenses	Monthly	$300	$300	$300	$300	$300	$300
Customer Consumables	Monthly	$60	$60	$60	$60	$60	$60
Electricity	Quarterly	$500	$167	$500	$0	$0	$500
Freight Fees	Monthly	$300	$300	$300	$300	$300	$300
Gas	Quarterly	$300	$100	$0	$300	$0	$0
Hire Purchase Payments	Monthly	$650	$650	$650	$650	$650	$650
Insurance	Annually	$3,000	$250	$0	$0	$0	$0
Interest Expense	Monthly	$520	$520	$520	$520	$520	$520
Internet Fees	Monthly	$150	$150	$0	$0	$150	$0
Lease Expenses	Monthly	$800	$800	$800	$800	$800	$800
License Fees	Annually	$1,200	$100	$700	$0	$0	$0
Merchant Fees	Monthly	$320	$320	$320	$320	$320	$320
Motor Vehicle rego & insurance	Annually	$1,500	$125	$0	$1,500	$0	$0
Motor Vehicle Fuel	Weekly	$80	$347	$347	$347	$347	$347
Motor Vehicle Repairs & Maint	Annually	$2,000	$167	$167	$167	$167	$167
Motor Vehicle Tolls	Weekly	$70	$303	$303	$303	$303	$303
Office Supplies	Monthly	$150	$150	$150	$150	$150	$150
Professional Memberships	Annually	$1,800	$150	$0	$1,800	$0	$0
Rental Expense	Fortnightly	$1,500	$3,250	$3,250	$3,250	$3,250	$3,250
Repairs and Maintenance	Annually	$6,000	$500	$500	$500	$500	$500
Replacements	Annually	$3,000	$250	$250	$250	$250	$250
Staff Amenities	Monthly	$300	$300	$300	$300	$300	$300
Subcontractor Expenses	Monthly	$520	$520	$520	$520	$520	$520
Subscription and Dues	Annually	$2,200	$183	$200	$0	$500	$0
Telephone (inc mobile)	Monthly	$550	$550	$550	$550	$550	$550
Travel Domestic	Monthly	$350	$350	$350	$350	$350	$350
Travel Overseas	Annually	$3,500	$292	$0	$3,500	$0	$0
Wages and Salaries	Weekly	$850	$3,683	$3,683	$3,683	$3,683	$3,683
Wages oncosts	Weekly	$85	$368	$368	$368	$368	$368
Website expenses	Monthly	$850	$850	$850	$850	$850	$850
Total Expenses			**$16,205**	**$16,088**	**$21,788**	**$15,338**	**$15,188**

FIGURE 7-2: Forecasting expenses for the months ahead.

If you've created an estimate of monthly expenses already (refer to the previous section), you have a head start for building a projection for the months ahead. However, here are some tips to help you along the way:

REMEMBER

- **Beware five-week wages months:** If you pay wages every week, bear in mind that every third month you'll get a month with five paydays, not four.
- **Show expenses in the month they occur:** You'll find some expenses occur only once a quarter or once a year (such as accounting fees or membership dues). For these expenses, you can simply enter the whole budget for the year in the month(s) when payment is going to fall due.

AHEAD OF THE PACK

- **Split large expenses into more detail:** If your expenses forecast includes any one expense that's more than 10 per cent of total expenses, see if you can split this expense up in more detail.

- **Think about seasonal variations:** Depending on your business, expenses can increase or decrease dramatically at different times of year.
- **Think about when you may take holidays:** Owner-operated businesses may need to increase wages expense during this time.
- **Use formulas to calculate related expenses:** If you're using a spreadsheet, set up formulas for any expense categories that are directly related. For example, if you know that wages oncosts average 10 per cent of wages, create a formula so that if you change the figure for wages in your spreadsheet, the figure for wages oncosts changes automatically, too.

Allowing for loan repayments and interest

If your business has borrowed money and you're paying off a business loan, deciding how to show loan repayments in your expenses budget can be quite tricky.

Imagine that you have a bank loan and your repayments are $1,000 per week. You've almost paid off this loan and you currently only have $15,000 left to repay. The interest on this loan only equals about $15 per week.

Any accountant will gladly explain that in terms of the profit of your business, the only expense that you can claim is the interest. However, when you're doing financial projections, this kind of analysis is too simplistic. The interest may be inconsequential, but budgeting $1,000 a week in repayments is not.

The best way to show loan repayments in your financial projections depends on the circumstances:

- If you decide to include both a Profit & Loss Projection and a Cashflow Projection in your workings, you should show the value of the interest expense in your Profit & Loss Projection, and the value of the entire loan repayment in your Cashflow Projection.
- If you're only doing a Profit & Loss Projection at this point, stay on the side of caution and show the full value of the loan repayment in your expenses worksheet. This way, the

> final net profit that you arrive at in your projections will be as close as possible to your likely surplus in cash.

See Chapter 9 for more on Profit & Loss and Cashflow Projections.

Allowing for personal and company tax

One of the questions people often ask is whether to include personal or company tax in their expenses worksheet. The answer depends on whether your business is structured as a sole trader, partnership or company.

If your business operates as a sole trader or partnership, you're responsible for paying tax on any profit that the business makes. The amount of tax you pay depends on many factors, including whether you have any sources of income other than the business. Generally, I don't include personal income tax as an expense on financial projections for a business.

If your business has a company structure, you do need to include company tax expense on your expenses worksheet. Typically, if you're using a spreadsheet to forecast your expenses, the best approach is to add two extra lines below the row showing Net Profit. The first line is Company Tax Expense, and the second line is Net Profit After Company Tax.

Building Profit Projections

So far in this chapter, I've explained how to calculate the cost of your sales and how to build a worksheet that forecasts expenses. If you've been reading this book consecutively, you know that in Chapters 5 and 6, I explain how to set prices and create sales forecasts. In the next few pages of this chapter, I join the pieces of the puzzle together to show you how to build a 12-month profit projection.

The examples in this chapter use a spreadsheet for creating profit projections and, for me, spreadsheets tend to be my preferred poison. However, you may choose to use a business-planning app to arrive at the same point, and that's fine too.

Step one: Starting with sales

In Chapter 6, I talk about setting sales targets in detail. The idea is that you list the names of the months along the top and then, starting from the current month or the month that you intend to start trading, you list your predicted sales in each column.

REMEMBER

If possible, try to split sales into different categories, such as type of product, service provided, customer type, location or distribution method, with a final row that shows Total Sales for each month. In general, I find the extra level of detail helps keep sales predictions more realistic.

Step two: Adding variable costs

Earlier in this chapter, in 'Understanding Cost of Sales', I talk about calculating the cost of your sales. The next step in building your profit projection is to make a prediction about how much your sales will cost each month, based on the sales projections you've already made.

Quite how you do this depends on the type of business.

If you have a service business with no employees and no variable costs

This type of business has the simplest of financial forecasts. Simply enter the heading 'Variable Costs' and leave the figures in this row blank. (However, note that if you forecast substantial growth for your business, you may not be able to do all the work yourself, and you may need to hire subcontractors or use employee labour — creating variable costs.)

If you have a service business and you use employee or subcontract labour

Examples of this kind of business could be a plumber who subcontracts out some work, a party business that pays employees a casual rate to go to parties, a builder who uses labourers or a consultant bookkeeping service that hires lots of bookkeepers.

To show the cost of labour accurately, ensure that your sales projections for the next 12 months separate out sales where you're going to do the work, and sales where you'll get employees or subcontractors to do the work. Show your variable costs below your sales, similar to Figure 7-3. (For ease of display, I only show six months in this example, but I'm sure you get the general idea!) In this example, I know that for jobs that I don't do myself, I'll spend 60 cents in every dollar earned on labour, and I use a

	A	B	C	D	E	F	G
1		Jul	Aug	Sep	Oct	Nov	Dec
2	Sales - Owner Delivering Service	5000	5100	5200	5300	5410	4900
3	Sales - Subcontractor Delivering Service	1000	1000	1000	1100	1600	1500
4	**Total Sales**	6000	6100	6200	6400	7010	6400
5							
6	**Cost of Sales**						
7	Subcontractors Expense	600	600	600	660	960	900
8	Materials @ 15% of Sales	900	915	930	960	1052	960
9	Tool Hire	300	300	300	300	300	300
10	**Total Cost of Sales**	1800	1815	1830	1920	2312	2160
11							
12	**Gross Profit**	4200	4285	4370	4480	4698	4240
13							

FIGURE 7-3: Building a gross profit projection for a service with employees or subcontractors.

formula to calculate these costs. That way, every time I alter my sales forecasts, my labour costs change automatically.

Don't forget to add other variable costs here as separate rows also, such as commissions, consumables, materials or room hire.

If you buy and sell products

Sometimes, the idea with variable costs is that they are a stable percentage of income. For example, if you're a retailer, the cost of the goods you buy is probably a similar percentage of sales each time you make a sale.

If your variable costs are always a pretty stable percentage of sales, the trick is to set up your gross profit projection so that your variable costs calculate automatically. In other words, set up your worksheet so that if you increase sales, variable costs automatically increase as well.

For example, in Figure 7-4, the online bookseller knows that for every $100 of full-price books they sell, it costs them $60 to buy the books. In other words, their variable costs represent 60 per cent of sales. Similarly, they know that postage costs them, on average, 15 per cent of the sale value.

In this scenario, start by completing your sales projections for the next 12 months. (*Note:* I show only six months in my example, for space reasons.) Below these sales, insert rows that show the cost of making these sales. If you're using a spreadsheet, you can use formulas so that these costs update automatically whenever you change a sales figure.

	A	B	C	D	E	F	G	H
1			Cost as a % of sales					
2		Full-price books	60%					
3		Postage & Packaging	15%					
4								
5								
6			**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
7								
8		**Sales**	12,000	12,500	12,300	13,000	13,100	13,800
9								
10		*Less: Variable Expenses*						
11		Cost of Books for Resale	7,200	7,500	7,380	7,800	7,860	8,280
12		Postage & Packaging	1,800	1,875	1,845	1,950	1,965	2,070
13		Total Variable Expenses	9,000	9,375	9,225	9,750	9,825	10,350
14								
15		**Gross Profit**	3,000	3,125	3,075	3,250	3,275	3,450
16								
17								

FIGURE 7-4: Building a gross profit projection for a business selling products, calculating costs on a percentage basis.

Step three: Showing gross profit

As you probably know already, gross profit is equal to sales less variable costs. What you've done so far is create a projection showing month-by-month sales listed across 12 columns, followed by your variable costs for each of these months.

Refer to Figures 7-3 or 7-4 and you can see how I've created not only subtotals for sales and variable costs, but also a new row at the bottom called Gross Profit. I calculate this automatically by setting up a formula in each column that simply subtracts total costs from total sales.

If you like, you can even insert an extra row here that calculates the gross profit margin (to do this, divide total gross profit by total sales for each month, and multiply this by 100).

Step four: Adding expenses and revealing the bottom line

Earlier in this chapter, in 'Forecasting expenses for the year ahead', I explain how to create a 12-month projection for business expenses.

Now is the time for you to grab this projection, and copy and paste the information into the work you've done so far. You're almost there! Here's a summary of what you've done so far and how to pull this last section together:

1. **Start with a monthly sales projection for the next 12 months.**

   Refer to 'Step one: Starting with sales' earlier in this chapter. Ideally you'll have a few lines detailing the different kinds of sales, with a row for Total Sales at the bottom.

2. **Add a monthly cost of sales projection for the next 12 months.**

   Refer to 'Step two: Adding variable costs' earlier in this chapter. The detail required here depends entirely on the kind of business.

3. **Calculate the monthly gross profit projection for the next 12 months.**

   Total Sales less total Cost of Sales equals Gross Profit. Set up this calculation so it happens automatically.

4. **Add details of monthly expenses for the next 12 months.**

   You probably have at least a dozen or so rows here, if not many more, in order to show a good level of detail. (My example in Figure 7-5 is pretty simple in this regard, but again I'm sure you get the idea!)

	A	B	C	D	E	F	G	H
6			**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
7		**Total Sales**	12,000	12,500	12,300	13,000	13,100	13,800
8								
9		Less: Variable Expenses						
10		Cost of Books for Resale	7,200	7,500	7,380	7,800	7,860	8,280
11		Postage and Packaging	1,800	1,875	1,845	1,950	1,965	2,070
12		**Total Cost of Sales**	9,000	9,375	9,225	9,750	9,825	10,350
13								
14		**Gross Profit**	**3,000**	**3,125**	**3,075**	**3,250**	**3,275**	**3,450**
15								
16		Accounting Fees	0	500	0	0	500	0
17		Insurance	0	0	350	0	0	0
18		IT Expenses	320	320	320	320	320	320
19		Marketing Expenses	250	250	250	250	250	250
20		Motor Vehicle Expenses	350	350	350	350	350	350
21		Office Expenses	80	100	120	70	80	100
22		Professional Development	0	0	0	200	0	350
23		Software Subscriptions	220	220	220	220	220	220
24		Staff Wages	850	850	850	850	850	850
25		Superannuation	81	81	81	81	81	81
26		Travel	0	0	220	0	75	0
27		**Total Expenses**	2151	2671	2761	2341	2726	2521
28								
29		**Net Profit**	**849**	**454**	**314**	**909**	**549**	**929**
30								
31								

FIGURE 7-5: Compiling a monthly profit projection.

5. **Calculate the monthly net profit projection for the next 12 months.**

   Total Gross Profit less Total Expenses equals Net Profit. Set up this calculation so it happens automatically, and there you have it! A month-by-month prediction of your bottom line.

Keeping Things Real

While many people learn how to create financial projections quite quickly, I find that the figures they produce often bear little relationship to reality. In the next section of this chapter, I share a couple of techniques to ensure that your profit projections fall as close to reality as possible.

Playing with percentages

Many years ago (when young and foolish) I worked for a company that was always teetering on the verge of bankruptcy. They stayed in business far longer than they should have done because they were fantastic at convincing gullible investors and bank managers to lend them money. Part of the money-lending sell was based on glamorous profit projections showing that if only the requisite loan could be found, everything would prosper. The managers would sit in front of the computer, hour after hour, fiddling with projections until they arrived at figures that looked good (but, of course, had little bearing on reality).

This experience taught me how sensitive budgets and cashflows are to relatively small changes. Take your profit projections and boost sales by 10 per cent, every month. Chances are things look great. Then take the same profit projections, but this time pull sales down by 10 per cent, and maybe yank up expenses by 5 per cent. Doesn't look so crash-hot any more, I bet. Often, an adjustment as small as 2 per cent a month in sales or expenses makes a humungous difference to your bottom line.

Sticking with benchmarks

In order to stay honest with financial projections, especially if you haven't started your business yet, a good strategy is to find out how similar businesses are faring. For example, if you want to start a cafe, find out what an average cafe spends on wages as a percentage of turnover, or how much average profit it makes each year.

You can find out how other businesses in your industry are faring by using something called *business benchmarking*. Here are some ways to look for this info:

REMEMBER

- The ATO supplies many core business benchmark ratios for free. Go to `www.ato.gov.au/Business/Small-business-benchmarks` and search for your industry. (And now for a bonus tip: These benchmarks are what the ATO use to identify businesses as audit targets, so if your existing business falls far outside of these benchmarks, beware!)
- Ask your accountant whether they subscribe to a benchmark service.
- Visit `www.benchmarking.com.au`. This service isn't cheap, but the benchmark reports are very useful and highly detailed.

TRUE STORY

A client of mine had been struggling for many years with his general store, eking out a living and working long, hard hours. At my suggestion, he purchased a set of 'Corner Store/Mixed Business' benchmarks and he realised that his gross profit was far too low when compared to successful general stores, and his wages were too high. He installed a point-of-sale system, revamped his pricing and restructured wages (legally), and soon his business was looking much, much healthier.

Avoiding the typical pitfalls

In my experience reviewing financial projections, the biggest area of error is usually overestimating sales, particularly for new businesses with no history of trading. I talk more about sales forecasts in Chapter 6, where I stress the importance of setting detailed sales targets that are carefully backed with specific marketing strategies. Adding a random 10 per cent growth in sales per month without considering how you plan to achieve this increase is a recipe for failure.

REMEMBER

The second biggest area of error relates to calculating the costs of each sale. I find that manufacturers consistently underestimate the true cost of building or creating products. Similarly, service businesses often overestimate how many hours the owner can realistically bill for, and consequentially underestimate the cost of subcontract labour.

On a positive note, most business people are quite accurate when it comes to predicting expenses. However, one of the bugbears is understanding the impact your choice of business structure makes upon your profitability projections. Here's the rub: If your business operates as a company structure, your wages and superannuation show in your financial projections as an expense. If your business operates as a sole trader or partnership, wages don't show as an expense; rather, your projected net profit represents the wages you earn.

REMEMBER

The only way to get better at creating financial projections is to compare your forecasts against actuals each month, learning from your mistakes as you go.

Factoring Personal Expenses into the Equation

If you're starting a new business and you have very little savings or start-up capital, you may find you have very little to live on while building up your business. In this scenario, I strongly recommend you create a budget not only for business expenses, but for personal expenses too.

Here are the kinds of traps you want to avoid:

TRUE STORY

- I knew a couple who started a business at the beginning of the holiday season and had a few bumper months of trading. They drew all the available cash out of the business in order to survive, but then had no available cash when the business needed to get through lean times.
- Former clients of mine started up a business that did very well right from the start. However, they hadn't created a realistic budget for personal spending and, despite the business thriving, it didn't generate enough profit in that first year to cover mortgage repayments and school fees. Although they did muddle through in the end, that first year of trading was very stressful and left a legacy of huge credit card debt.
- A friend of mine started up a business that soon built to generate a steady but modest income. Being a happy-go-

> lucky personality, she spent money from her business pretty much as soon as it came in. However, 18 months after she opened doors for trading, she lodged her first tax return. She hadn't set any money aside for tax, and had to take out a personal loan to cover the debt.

Scrutinising one's personal spending has to be one of the more depressing ways to spend a rainy afternoon. Alternatively, a rough-and-ready way to figure out how much you need to live is to write down how much you've earned in the last 12 months, look up how much you've saved or how much savings you've used, and calculate the difference. Unless your personal circumstances have changed, this difference is going to be approximately the same as how much you need to live.

However, if you're starting or growing a business and you're willing to live a little leaner while things get off the ground, this method isn't good enough. The only way to really get a handle on your finances is to make a budget and try to live by it. This is the only way to see if you're spending more or less than you can afford.

You can find heaps of great apps online to help you manage your personal finances. If you haven't done so already, I recommend you start today! The simple act of recording every dollar you spend is one of the most powerful ways of taking control of this aspect of your life.

IN THIS CHAPTER

» Revealing your inner bean counter (you too can talk percentages)

» Calculating crucial margins for your own enterprise

» Seeing how much you have to sell to keep the wolf from your door

» Applying three quick tests to assess the health of your business

Chapter 8
Making Magic with Margins

From time to time, I work as a mentor at the local business college, helping people get started with their own small business. Things normally run pretty smoothly until we get to the session about calculating gross profit margins and figuring out break-even points. At this point, I often find myself catapulted into some weird kind of therapy role, dealing with the invisible scars left behind by unforgiving maths teachers and a flawed education system.

Fortunately, once you get your head around the basic concepts, calculating gross and net profit margins is very straightforward, and in this chapter, I try to explain these calculations in the most logical way that I can. So, if you're one of those people who gets a cold shiver when the word 'maths' is mentioned, please stick around. These next few pages could prove to be the cheapest therapy on the block.

Understanding Gross Profit

You've almost certainly heard of the terms *gross profit* or *gross profit margins* but are you entirely clear what these terms mean and why an understanding of these terms is so crucial to the profitability of your business? If you have even a moment's hesitation in answering 'yes' to this question, then read on . . .

Calculating gross profit

Put simply, gross profit is equal to sales less variable costs. A few examples may help bring this concept to life:

- A fashion retailer buys a skirt from the wholesaler for $20 and sells it for $50. Her gross profit is $30.
- A massage therapist charges $80 per massage but the therapy centre takes $25 as a booking and room fee. His gross profit is $55.
- A carpenter charges $800 for fixing a veranda. Materials cost $200 and labour for her apprentice costs $100. Her gross profit is $500.

REMEMBER

Sounds okay so far? Just bear in mind:

- Gross profit equals sales less variable costs.
- Gross profit is always more than net profit.
- The more you sell, the more gross profit you make.

Figuring gross profit margins

Following on from the examples in the preceding section, if a fashion retailer buys a skirt for $20 and sells it for $50, her gross profit is $30. Sounds easy, but how do I figure out her *gross profit margin*? As follows:

> *Gross profit margin* = gross profit divided by sales multiplied by 100

In this example, the retailer's gross profit margin equals $30 divided by $50 (that's gross profit divided by sales) multiplied by 100, which is 60 per cent.

As I mention earlier, the more you sell, the more gross profit you make. However, if your costs stay constant, your gross profit margin stays the same, regardless of how much you sell. For example, if this retailer sells two skirts, her sales would be $100, her costs would be $40, her gross profit would be $60, but her gross profit margin would still be the same, at 60 per cent.

Table 8-1 shows the gross profit and gross profit margins for the three examples from the preceding section.

TABLE 8-1 Calculating Gross Profit and Gross Profit Margin

	Fashion Retailer	Massage Therapist	Carpenter
Sell price	$50.00	$85.00	$800.00
Costs	$20.00	$25.00	$300.00
Gross Profit	$30.00	$60.00	$500.00
Gross Profit Margin	**60%**	**71%**	**63%**

TIP

Unless you know that something costs more to buy or to make than what you sold it for, both your gross profit and your gross profit margin should always be a positive figure.

Looking at margins over time

So far in this chapter, the examples I use talk about gross profit per unit sold or hour worked. However, in real life gross profit margins often vary from one transaction to the next (shopkeepers make a higher margin on gourmet jams than they do on milk, for example).

For this reason, it's good to be able to calculate your average gross profit margins over a period of time. Here's how some different kinds of businesses go about calculating their gross profit:

- A builder constructs a house that then sells for $250,000. He spends $180,000 on materials and labour to build this house. His gross profit on the job is $70,000, and his gross profit margin is 28 per cent.

- A couple making homemade chilli sauce that they sell in all different shapes and sizes, and at different prices, can see that they made $80,000 in sales over the last 12 months and spent $20,000 on ingredients, bottles, labelling and freight. Their gross profit for the year is $60,000, and their average gross profit margin is 75 per cent.
- A fashionista who buys second-hand clothes and resells them on eBay can see that she sold $2,500 on eBay during the month and spent $1,300 on buying clothes and postage. Her gross profit for the month is $1,200, and average gross profit margin is 48 per cent.

Analysing Margins for Your Own Business

Have you been reading this chapter and thinking to yourself that this theory is all very well, but you're not a retailer, a carpenter or a massage therapist? If so, never fear. In the following sections I explain how to apply the principles of gross and net profit to your own business.

Calculating margins when you charge by the hour

If you have a service business and you charge by the hour, calculating your gross profit can be blindingly easy. Why? Because, sometimes, a service business has no variable costs and gross profit equals 100 per cent of income. Read on to find out more.

Here's how you work out your gross profit and gross profit margin if you have a service business:

1. **Write down your hourly charge-out rate, not including any GST that you charge to customers.**
2. **Ask yourself whether any variable costs are associated with your service and, if so, calculate how much these costs are per hour.**

   The most likely cost for a service business is employees or subcontract labour. For example, when I ran a contract book-keeping service, I paid my contractors an hourly rate for doing bookkeeping. This was a variable cost associated with my service.

If you're a sole owner-operator with no employees, you may find that no variable costs are associated with your service.

3. **Subtract the cost you calculated in Step 2 from the hourly rate from Step 1.**

   This is your gross profit for this service. If you have no variable costs associated with your service, your hourly gross profit is the same as your hourly charge-out rate.

4. **Divide the gross profit you calculated in Step 3 by the hourly rate from Step 1, and divide your result by 100.**

   If you have no variable costs associated with your service, your gross profit margin will be 100 per cent.

5. **Consider the profitability of your service model.**

   AHEAD OF THE PACK

   Most service businesses need a decent gross profit margin in order to survive. If you're subcontracting out your services, don't underestimate the margin you'll need in order to cover all your business expenses. For example, if you're charging customers $50 per hour but paying employees $35 per hour, leaving yourself with a measly gross profit margin of 30 per cent, you're almost certainly going to be doing things tough.

Calculating margins when you sell products

If you buy or manufacture items that you sell to others, each item has a separate gross profit margin. If you have accounting software and you use this software to track your inventory, you'll be able to generate reports that calculate gross profit margins for you. However, if you don't have this resource, grab a calculator and work through the following for each item you sell:

1. **Write down the sell price of this item, not including any GST that you charge to customers.**

   If the sell price varies depending on the customer, do the analysis for each price you sell this item for.

2. **Write down the cost of this item.**

   If you buy this item from someone else, write down the total cost of purchasing this item, including freight but not including any GST. If you manufacture this item, write down the total cost of all materials and production labour.

3. **Subtract the cost you calculated in Step 2 from the sell price you calculated in Step 1.**

   This is your gross profit for this item.

4. **Divide the gross profit you calculated in Step 3 by the sell price you calculated in Step 1, and divide your result by 100.**

5. **Consider the results and your fate in life.**

   REMEMBER

   Number crunching is not an end in itself. Does this margin seem reasonable? If you're not sure, ask around other people who work in the same industry as you, and try to get a sense of what margins you should expect.

TIP

Always bear in mind that, so long as your pricing policies remain consistent, your gross profit margin should stay relatively constant, no matter how much you sell.

Calculating margins if you do big projects

If you do lots of big projects over the course of a year — maybe you're a builder, you do custom manufacturing or you do big contract consultancy jobs — you're going to find it tricky to calculate your hourly gross profit, or your gross profit per unit sold. A different tack is required:

1. **Look at your total sales for 12 months, not including GST.**

   I'm talking about total sales for all the different products that you sell, combined. If you're looking at a Profit & Loss report to get this figure, don't include things such as interest income, or sundry income from services.

2. **Add up your total variable costs for 12 months, not including GST.**

   If you're an owner-operator with no employees running a service business, you may find that no variable costs are associated with your service. Otherwise, if you're unsure how to figure out what your variable costs are, refer to Chapter 7, where I talk about these costs in more detail.

3. **Subtract the total costs you calculated in Step 2 from the total sales you calculated in Step 1.**

   This is your gross profit for the past 12 months.

4. **Divide the gross profit you calculated in Step 3 by the total sales you calculated in Step 1, and divide your result by 100.**
5. **Review your overall profitability.**

   What makes an acceptable gross profit margin varies from business to business. However, what's important for you is to be aware of your gross profit margin and ensure that it stays consistent over time.

Understanding why gross profit is such a big deal

So far in this chapter, I've explained how to calculate gross profit and gross profit margins, but I haven't reflected much on why it's important to do these calculations.

Often, understanding the relationship between sales and gross profit for your own business isn't something that means much at first. Rather, it's the trends and changes in gross profit margins that provide insight.

I got a call from a private investigator many years ago, who'd been asked to investigate an alleged fraud in a computer retail company. The owner of the company suspected his bookkeeper of siphoning off funds, but couldn't identify how it was happening. The reason for these suspicions? The gross profit margin of his company had always been stable at 35 per cent, but in recent months had fallen to 32 per cent. (I did assist with the investigation and, sadly, we were able to confirm the owner's worst fears.)

Other than identifying a suspicious trend, another reason for analysing gross profit margins is to help with budgeting. Look at your sales figures and ask yourself what difference a 5 per cent increase in gross profit would make in the bottom line of your Profit & Loss. Often an increase of just 5 per cent can make the difference between a business thriving, or only just surviving.

My last reason for keeping tabs on gross profit margins is that it enables you to compare your business with others in the same industry. This process is called *benchmarking*, something I talk about more in Chapter 7.

Identifying Your Tipping Point

Your break-even point is the number of dollars you need to earn in any given period in order to cover your costs. Or, to put it differently, the total sales you have to make so that you make neither a loss nor a profit.

Most business textbooks talk about your break-even point only in terms of the *business* breaking even. In other words, the break-even point is the point at which sales are high enough to cover the costs of your business. However, you can also think of your break-even point in terms of covering not only your business costs, but your personal expenses too.

In real life, I find that people use break-even to refer to three totally different things:

- **Business break-even point:** When you calculate your business break-even point, you calculate the sales the business has to make in order to meet its business expenses. In other words, if the business breaks even, it makes neither a profit nor a loss. This calculation is most relevant for businesses with a company structure where directors' salaries (owner salaries) are factored into the fixed expenses of the company.
- **Business/personal break-even point:** When you calculate your business/personal break-even point, you calculate the sales the business has to make in order to meet business expenses and pay you — as the business owner — enough to cover your personal expenses.

  Most business guides don't include any reference to personal expenses when calculating break-even, but I think that doing so is important for small businesses with a single owner-operator. After all, even if your business does make a profit, this profit may not be enough if the business is your sole source of income and the profit generated isn't enough to cover your basic living expenses.
- **Cash break-even point:** When you calculate your *cash break-even point*, you calculate the sales you have to make in order for your cash out to match your cash in over a specified

period of time (usually 12 months). In this scenario, cash out could include things such as new equipment or business set-up costs, and cash in could include business loans or money that you have set aside in savings.

Calculating your cash break-even point provides a simpler approach to doing a proper Cashflow Projection (a topic I cover in detail in Chapter 9). However, a cashflow is a more accurate and detailed approach and is preferable if your business offers credit to customers or has inventory.

In this section, I cover how to calculate business break-even, and business/personal break-even. I look at break-even from a cash perspective towards the end of this chapter (see the section 'Looking at Things from a Cash Perspective').

Understanding the concept of break-even

The basic formula for calculating your business break-even point is easy:

Break-even point = Fixed expenses divided by gross profit margin

Imagine I have a friend (I'll call her Annie) who has a cafe on the main street. Her fixed expenses are $4,500 per week (one waitress, one kitchenhand, insurance, rent and so on). Overall, on average she makes a gross profit margin of about 60 per cent. (In other words, if she sells a focaccia for $10, the ingredients cost her $4; if she sells a coffee for $4, the ingredients cost $1.60.)

Annie's business break-even point is going to equal fixed expenses (that's $4,500 per week) divided by her gross profit margin (60 per cent), which is $7,500. In other words, she has to generate $7,500 in sales just to break even and cover her basic expenses. Figure 8-1 shows this principle in action.

	A	B	C
1			
2	Average Gross Profit Margin	60%	Ingredients cost 40 cents for every dollar sold
3			
4	Fixed Expenses	$ 4,500	Staff, rent, insurance, and so on
5			
6	Break-even point	**$ 7,500**	Fixed expenses divided by gross profit margin
7			

FIGURE 8-1: Calculating business break-even point.

Think this through to see how it works out. If Annie generates \$7,500 in income, she'll have to pay out \$3,000 in supplies (that's the cost of food at 40 cents in the dollar). This leaves \$4,500 gross profit, which is exactly the amount she needs to cover her fixed expenses. This figure is Annie's business break-even point.

Factoring personal expenses into the equation

The break-even chat in the preceding section is all very well, but if your business has a sole trader or partnership structure, you probably need to do more than cover your business expenses, in that you'll need to generate enough income to cover personal expenses as well. (I'm assuming that if your business has a company structure, you already pay yourself a wage, and so your wage forms part of your fixed expenses.)

To bring personal expenses into the picture, you need to repeat the business break-even calculation, but this time include the amount of cash you need to generate to cover personal expenses.

Building on the example earlier in this chapter, here's how to calculate break-even in this kind of situation. Imagine that:

- Annie has a cafe with fixed expenses of \$4,500 per week. These expenses don't include any wages for herself.
- She needs to generate a minimum of \$500 per week in order to cover her personal living expenses.
- She makes an average gross profit margin of 60 per cent.

The formula is the same; however, this time fixed expenses need to include not just business expenses but personal expenses also.

Break-even point = Fixed expenses (including personal expenses) divided by gross profit margin

You can see how the sums pan out in Figure 8-2. Annie needs to earn an additional \$833 per week (that's \$8333 in total) in order for her business to break even and for her to generate enough to live on.

	A	B	C
1			
2	Average Gross Profit Margin	60%	Ingredients cost 40 cents for every dollar sold
3			
4	Fixed Business Expenses	$ 4,500	Staff, rent, insurance, and so on
5	Fixed Personal Expenses	$ 500	Minimum funds Annie needs to survive
6	Total Fixed Expenses	$ 5,000	
7			
8	Break-even point	$ 8,333.33	Fixed expenses divided by gross profit margin

FIGURE 8-2: Calculating break-even point to cover both business and personal expenses.

Putting theory into practice

Are you ready to calculate the break-even point for your own business? Just before I launch into a step-by-step explanation, I'm going to quickly recap the difference between variable costs and fixed expenses. (For more on this topic, scoot back to Chapter 7.)

- *Variable costs* (also sometimes called direct costs or cost of goods sold) are the costs that go up and down in direct relation to your sales, and typically include commissions, the cost of the goods you buy to resell to customers, raw materials and subcontract labour.
- *Fixed expenses* are expenses that stay constant, regardless of whether your sales go up and down. Typical fixed expenses for your business may include accounting fees, bank fees, computer expenses, electricity, insurance, motor vehicles, rental, stationery and wages.

Got all that straight? Then here goes:

1. **Open a new worksheet in Excel (or any other spreadsheet software).**
2. **Enter your gross profit margin on the first line, similar to Figure 8-2.**

   To calculate your gross profit margin, grab your average gross profit (per unit, product, service provided, month or per year), divide this by sales (again, per unit, product, service provided, month or per year) and multiply by 100. If you're not sure how to do this calculation, make your way back to earlier in this chapter, where I explain how to calculate your gross profit margin in detail.

By the way, if you are an owner-operated service business with no employees and no variable costs, your gross profit margin will be 100 per cent.

REMEMBER

Format your gross profit margin as a percentage. To do this, simply click the % button on the main toolbar.

3. **Add the fixed expenses for your business to the next line of the worksheet.**

   If you're not sure how much your fixed expenses are, Chapter 7 focuses on calculating the fixed expenses for your business. I usually like to calculate break-even and think of fixed expenses on a monthly basis, but you can choose any period of time that makes sense to you.

4. **If your fixed expenses don't include any wages for yourself, add whatever you need for living expenses to the next line of the worksheet.**

   Be realistic about how much you need to survive.

5. **Total up your business and personal fixed expenses.**

   Figure 8-2 shows the general idea.

6. **Add a row that calculates break-even point, dividing total fixed expenses by the average gross profit margin.**

   In Figure 8-2, the formula for the break-even point is =B6/B2. Simple. You now know what you have to achieve in sales in order to meet your business expenses.

7. **If it suits, express the break-even point in a different time period.**

   In Step 3, if you express your fixed expenses as total expenses for a month, consequently your break-even point calculates what you need to achieve in sales per month. However, maybe it makes more sense to you to look at your break-even point per day, per week or per year.

8. **If relevant to your business, express the break-even point in units sold, or the number of services provided, rather than dollars.**

   For example, if your break-even point is $10,000 a week and you're selling custom-built handmade guitars at $5,000 a pop, you know you have to sell two guitars a week to break even. Or if your break-even point is $4,000 a month and you're mowing lawns at an average of $50 a lawn, you know you have to mow 80 lawns a month to break even.

ALLOWING FOR PERSONAL AND COMPANY TAX

Are you wondering whether you should include personal income tax or company tax in your break-even calculations? The answer depends on whether your business is structured as a sole trader, partnership or company.

If you're a sole trader or partnership, you're responsible for paying tax on any profit that the business makes. The amount of tax you pay depends on many factors, including whether you have any sources of income other than the business. Depending on your circumstances, you may wish to allow for personal income tax when calculating how much you need to draw from your business to cover a living wage for yourself.

If your business has a company structure, your own wages are almost certainly included in company expenses. For this reason, you don't need to include company tax expense when calculating break-even: If the company is making neither a profit nor a loss, company tax isn't an issue.

REMEMBER

Calculating a break-even point using the method shown in the preceding steps gives you a general indication of how much income your business needs to generate in order to make neither a profit nor a loss over a sustained period of time. However, this calculation doesn't take into account the cash requirements for a business. A business can make a profit but still have negative cashflow (and vice versa), because of factors such as set-up costs, extending customer credit or building inventory. For a more detailed explanation of cashflow management, see Chapter 9.

Changing Your Break-Even Point

If you find that your business is trading unprofitably, and despite your best efforts you can't get your sales high enough to meet your break-even point, your only option may be to change your break-even point.

Using the principles of break-even calculations, you have three possible solutions:

- Raise your prices (which is often not an option if you're finding it hard to make enough sales).
- Cut your variable costs (that is, the costs of production or providing your service).
- Cut your fixed costs.

For example, if I go back to the cafe owner whose calculations are shown in Figure 8-2, I can see that Annie needs to generate $8,333 per week just to pay expenses. Imagine that the local council is planning major road work and Annie knows that her turnover is going to be affected. She reckons she'll probably generate only about $6,000 a week while the work is going on.

Annie goes to the worksheet where she calculated her break-even and experiments with the different scenarios, shown in Figure 8-3.

- In Strategy One, Annie can see that she'd have to increase her gross profit margin to 83.5 per cent to break even if sales dropped to $6,000 per week. She knows she can't cut food costs or increase prices this much, so this strategy doesn't seem practical.
- In Strategy Two, she keeps her margins the same but cuts her expenses by $1,400 a week. This seems to work, but she doesn't know if she can cut expenses by this much and still stay open.
- In Strategy Three, Annie increases her margin by 5 per cent and cuts her expenses by $1,000 a week. She can see that this will work, and thinks that cutting her expenses by this much is probably possible, especially if her landlord agrees to a temporary reduction in rent.

AHEAD OF THE PACK

The handy thing about understanding your break-even point in this kind of detail is that you can take pre-emptive action if you know that costs are going to increase or sales are going to decrease.

	A	B	C	D	E
1	**CURRENT BREAK-EVEN POINT**			**STRATEGY ONE**	
2	Average Gross Profit Margin	60%		Average Gross Profit Margin	83.5%
3					
4	Fixed Expenses Business	$ 4,500.00		Fixed Expenses Business	$ 4,500.00
5	Fixed Expenses Personal	$ 500.00		Fixed Expenses Personal	$ 500.00
6	Total Fixed Expenses	$ 5,000.00		Total Fixed Expenses	$ 5,000.00
7					
8	Break-even Point	**$ 8,333.33**		Break-even Point	**$ 5,988.02**
9					
10	**STRATEGY TWO**			**STRATEGY THREE**	
11	Average Gross Profit Margin	60%		Average Gross Profit Margin	65%
12					
13	Fixed Expenses Business	$ 3,100.00		Fixed Expenses Business	$ 3,500.00
14	Fixed Expenses Personal	$ 500.00		Fixed Expenses Personal	$ 400.00
15	Total Fixed Expenses	$ 3,600.00		Total Fixed Expenses	$ 3,900.00
16					
17	Break-even Point	**$ 6,000.00**		Break-even Point	**$ 6,000.00**

FIGURE 8-3: Understanding your break-even point enables you to plan ahead for changes in trading conditions.

WHAT DOES SOMETHING REALLY COST?

One of the things that can do your head in when working with costings is the question of how to apportion the fixed costs of your business across every item sold or every service provided.

Think of a business selling homemade fudge. The cost of ingredients for fudge stays the same for every packet sold, but the fixed costs (premises rental, equipment rental, insurance and so on), when calculated on a per packet basis, go up or down depending on the number of packets of fudge made.

For example, if the fixed costs are $700 a week and the business makes 700 packets of fudge that week, the fixed costs are $1 per packet. But if the business makes 1,400 packets of fudge, the fixed costs are only 50 cents per packet.

For this reason, arriving at the 'true' cost of an item can sometimes be hard. For you as a business owner, the challenge in this respect is two-fold: First, be ever vigilant about controlling your fixed costs; second, always try to maximise production to make as full use of resources as you can. This may mean making full use of rented premises, keeping staff productive and, of course, ensuring that sales are as high as they can possibly be given this level of expenses. By maximising resources in this way, you keep the fixed costs per unit as low as possible.

Looking at Things from a Cash Perspective

When I was teaching at our local business college, one of the exercises teachers were asked to do with the new students (all of whom were planning their new businesses) was to do a break-even analysis from a cash perspective for the first 12 months of trading.

At first, I was a bit sceptical of this somewhat simplistic approach, because the only way to be really sure how things stand from a cash perspective is to do a proper Cashflow Projection, a topic I cover in Chapter 9. However, if you don't offer credit to customers and you don't carry inventory, this cash break-even analysis can be a very powerful and relatively simple-to-use technique.

The idea is that you don't look simply at business profitability, but also at how much cash you have in the bank to begin with, how much cash you intend to spend on setting up and how much money (if any) you intend to borrow.

You can see how this analysis looks in Figure 8-4, where I take the figures for Annie's cafe business (the example I use earlier in this chapter), but imagine that she's in her first 12 months of trading. You can see that when I factor in her existing savings and the fact that she's borrowing slightly more than she needs to spend for the set-up, her break-even point drops from $8,333 to $7,467 per week. What this means, in practical terms, is that although in the long-term Annie does need to generate $8,333 in sales every week in order to break-even, she only has to average $7,467 per week for the first 12 months. This is probably a good thing, because most businesses need some time to build up trading.

	A	B	C	D
1	Calculating the 'Cash' Break-Even Point for Annie's Café for First 12 Months			
2				
3	Annie's Average Gross Profit Margin	60%		
4				
5	**Incoming or Outgoing First 12 Months**	**Amount**		**Explanation**
6	Annie's savings available	-$ 20,000.00		Annie's savings before she starts the business, entered as a minus amount
7	Other sources of income for the first 12 months	-$ 5,000.00		Loan from Annie's parents, entered as a minus amount
8	Proceeds from business loan	-$ 80,000.00		Loan from bank, entered as a minus amount
9	Money required for setup expenses	$ 75,000.00		
10	Total fixed expenses (business) for the first 12 months	$ 234,000.00		Annie doesn't include variable costs or wages paid to herself, but does include loan repayments
11	Total personal expenses for the first 12 months	$ 26,000.00		Annie reckons she can just survive on $500 per week
12	Goal to have as balance in the bank	$ 3,000.00		Annie reckons she needs at least $3k in the bank so she can sleep at night
13	Total	**$ 233,000.00**		Net outgoings
14				
15	Break-even point over 12 months	**$ 388,333.33**		Level of sales required to break even, from a cash perspective, over the next 12 months. (Equals net outgoings divided by average gross profit margin)
16	Monthly break-even point	$ 32,361.11		
17	Weekly break-even point	$ 7,467.95		
18				

FIGURE 8-4: Calculating what you need to do to break even in the first 12 months.

Understanding Other Ratios

Turn to almost any business book and you're likely to find a rather dry chapter devoted to ratio analysis, introducing pages of gloomy equations that are meant to cast razor-sharp insights into the health of your business. All of these ratios are handy for multimillion-dollar companies listed on the stock exchange, but for smaller businesses, I find only a handful of ratios are really useful.

In the last section of this chapter, I cover three essential ratios: Your accounts receivable ratio, your turnover ratio and your return on investment ratio.

Assessing your accounts receivable ratio

Your *accounts receivable ratio* calculates how many days, on average, it takes between you invoicing a customer and getting paid. If you keep an eye on this ratio and how it changes from month to month or from year to year, you can get a real insight into the effectiveness of your invoice collection procedures.

MONEY STUFF

To calculate this ratio, simply divide your total sales for the past 12 months by the current value of accounts receivable. For example, if total sales for the last 12 months for your business were $250,000 and you're currently owed $50,000, your accounts receivable ratio is:

$250,000 ÷ $50,000 = 5

If you get really excited by this calculation, go one step further and divide the number of days in a year by this ratio:

365 ÷ 5 = 73

This ratio means that it takes an average of 73 days for your customers to pay up, which incidentally would be a pretty pitiful average in anyone's book.

Looking at your turnover ratio

If you carry stock for resale as part of your business, your *turnover ratio* is a handy analysis tool, calculated as follows:

Turnover ratio = total sales divided by cost value of stock on hand

For example, if annual sales for the last 12 months for your business were $800,000 and the current cost value of your stock on hand is $80,000, your turnover ratio is:

$800,000 ÷ $80,000 = 10

Now divide the number of days in a year by this ratio:

365 ÷ 10 = 36.5

In other words, it takes an average of 36 days for a stock item to sell. Whether this average is good or bad depends on the kind of business you're running (an average of 36 days for selling something would be poor for a store selling food, but excellent for a store selling electrical goods).

If you have a high turnover ratio, you have less money tied up in stock, new products to attract customers and higher sales for the same amount of space. If you have a low turnover ratio, chances are you're investing in some dud stock or buying far more than you need at one time.

REMEMBER

Every product has to pay its own way, in terms of both the space it takes up in your shop or warehouse and the interest on the capital you have tied up in it. If a product turns over slowly, taking up valuable shelf or floor space while collecting dust, you want a handsome profit margin as your reward. On the other hand, if a product turns over before you can say 'knife', it doesn't need to make quite as high a profit margin.

Scrutinising your return on investment

One final balance sheet ratio that I think is worth calculating is your *return on investment ratio*. This ratio answers the important question of whether your business is making a better return on your money than you'd get if you put it in a low-risk investment such as a bank term deposit. Here's the formula:

Return on investment = net profit divided by your investment in the business

MONEY STUFF

An example may help you understand return on investment more fully. Imagine you've invested $200,000 of your savings to buy a cafe. In the last three years, after paying yourself a decent wage for the hours you spend working in the business, you've averaged a net profit of $5,000 per year. Your return on investment is $5,000 divided by $200,000 multiplied by 100, which equals 2.5 per cent.

In theory, if the interest rates for term deposits or share market returns are more than 2.5 per cent, you could spare yourself the hassle and risk of running a business and instead make more by investing your assets elsewhere.

Although number-crunchers love this kind of pillow talk, I don't always agree. Looking at percentage rates of return doesn't take into account some of the more intangible benefits of being in business for oneself, such as the work/lifestyle balance, being your own boss, doing something you're passionate about, or being able to live in a regional area where jobs are scarce.

IN THIS CHAPTER

» Getting your bookkeeping in order

» Translating your Profit & Loss report

» Unlocking the secrets of your Balance Sheet

» Understanding the sad tale of why profit doesn't always equal cash

» Making out with budgets

» Predicting if you're going to be in the red . . . or the black

Chapter 9
Using Reports to Boost Your Profits

In this chapter, I talk about the very serious topic of how to understand financial reports. After all, if your goal is to increase the profitability of your business, the first step is to accurately understand your business financials.

I also explain some of the deeper mysteries of life, such as how your Profit & Loss reports might look rosy, yet you have no cash in the bank, what the difference is between a budget and a cashflow and how to divvy up 15 Smarties evenly between four friends (just kidding on that last one).

Placing the Horse before the Cart

In order to generate financial reports for your business (and hence make plans for profits and more), you're first going to need to get your bookkeeping systems in place.

I'm not particularly invested in what software you sign up for — MYOB, QuickBooks, Reckon and Xero are all fine tools for the job — but I do emphatically recommend you subscribe to decent accounting software, and you ensure that you do the following:

- **Track all income, along with any GST you collect:** If you're using accounting software, generate customer invoices for all income received, and record payments against these invoices.
- **Stay on top of what customers owe you:** Weekly debtor reports and rigorous debt-chasing procedures are a must.
- **Track all expenses, along with any GST paid:** If you pay for most expenses from a business bank account or credit card and you use accounting software and bank feeds, recording expenses is child's play. When the transaction appears in your accounting software, all you have to do is select the correct category (advertising, bank charges, computer expenses, rent and so on), and your work is done.
- **Keep track of supplier accounts and how much you owe:** For smaller businesses, this can be as simple as paying immediately for almost all bills, so that you always know where you stand, or keeping a folder with 'Bills To Be Paid' written on it. For more established businesses with lots of supplier accounts, or for businesses that report for GST on an accrual basis, it makes more sense to enter supplier invoices in your accounting software as soon as you receive them. This way, you always know how much you owe at any given time.
- **Record transactions for any business expenses that don't appear in your bank feeds:** You need to do this if you pay for expenses using cash or a personal bank account.
- **Record all employee pays and upload the pay details each pay cycle using Single Touch Payroll (STP):** It's mandatory to have payroll software if you have employees so that you can upload summary data from pay transactions to the Australian Tax Office for every pay cycle.

REMEMBER

- **Reconcile bank accounts regularly:** Without going into all the technicalities, reconciling your bank account involves matching your books against your bank or credit card statements and checking that the two sets of figures agree with one another. Boring as bat poo, I admit, but this process is absolutely essential to produce reliable figures.

With these systems in place, you're ready to generate meaningful financial reports for your business. Unsurprisingly, that's what the rest of this chapter is all about.

Telling a Story with Your Profit & Loss Report

A Profit & Loss report is a story, telling you how your business has fared over the past few days, months or even years. It lists sales at the top, purchases and expenses in the middle, and a final profit (or loss) figure at the bottom, giving a quick and simple indication of whether your business is blooming with health or is as sick as a dog. If you're using accounting software, a Profit & Loss report is a completely standard report that you are able to generate at any time.

Understanding how it all works

Although most Profit & Loss reports are pretty easy to understand, don't be tempted into thinking that a profit is cause for partying and a loss is reason for a maudlin drinking bout. The important thing is to understand not only *what* the bottom line is, but also *why* you made a profit (or loss!) in the first place. (See Figure 9-1 for an example Profit & Loss report.)

REMEMBER

To understand your Profit & Loss report, try this: Carve out some space for yourself (easier said than done, I know), sit down and read every single line of your report, slowly and thoughtfully. Think of this process as being rather like one of those spot-the-difference puzzles you did as a kid. But instead of spotting the cat with three legs or the woman wearing a saucepan on her head, look carefully at the following:

- **Sales figures:** Look at sales for the month and see whether they seem reasonable. By the way, GST isn't included in total sales figures on a Profit & Loss report.

REMEMBER

- **Any odd figures:** Be critical and double-check that every single line on the report makes sense. No-one knows your business like you do — your gut feeling about which figures are right and which figures are wrong is usually spot-on.

REALISM CITY PROFIT & LOSS REPORT JANUARY				
	This Month ($)	% of Sales	Same Month Last Year ($)	LY % of Sales
Sales - Clothing	32,000	49%	22,500	38%
Sales - Jewellery	27,000	41%	29,500	49%
Sales - Giftware	6,200	10%	8,000	13%
Total Income	65,200	100%	60,000	100%
Purchases - stock	41,250	63%	34,200	57%
Gross Profit	23,950	37%	25,800	43%
Advertising	750	1%	920	2%
Bank Charges	60	0%	110	0%
Electricity/Gas	370	1%	400	1%
Motor Vehicle	963	1%	1,600	3%
Postage & Stationery	250	0%	270	0%
Rental	3,600	6%	3,200	5%
Salaries/Wages	5,462	8%	4,620	8%
Superannuation	519	1%	460	1%
Total Expenses	11,974	18%	11,580	19%
Net Profit	**11,976**	**18%**	**14,220**	**24%**

FIGURE 9-1: A simple Profit & Loss report.

MONEY STUFF

- **Gross profit margins:** For retailers, wholesalers and manufacturers, your gross profit margin is crucial and should stay pretty constant from one month to the next. (I talk more about profit margins in Chapter 8.)
- **Relationships between different accounts:** Notice the '% of Sales' column in Figure 9-1? I like having this column in my Profit & Loss report because it shows me how different expenses move in tandem with sales. For example, if wages go up, hopefully sales go up too.
- **This year's figures compared to last year's:** Comparing one year against another is a great way to get an overview of where your business is heading. For example, in Figure 9-1, although sales are up compared to the same month in the previous year, the gross profit margin is down and expenses haven't changed significantly, meaning less profit in the final wash-up.

Looking at sales

I'm not going to state the obvious and say what a good idea looking at your sales figures each month is, 'cos I'm pretty sure you're doing this already. Instead, I want to share an idea about how you can look at your sales figures in a bit more detail.

Ask yourself what different types of income you earn, and whether you might be able to report this income into different categories. For example, maybe you're a builder who earns money from the work you do on new houses, renovations, extensions and landscaping. Maybe you're like me, and earn money from a combination of writing, consulting and teaching. Or, maybe you run a newsagency that doubles as a post office and dry-cleaning agency.

As soon as you arrive at some kind of split, modify your bookkeeping to incorporate these different categories. (With accounting software, you simply add new income accounts in your accounts list.) Start to categorise all your income into these groups so that this information can appear on your Profit & Loss reports, similar to how the sales figures for clothing, jewellery and giftware show up separately in Figure 9-1. You can see, at a glance, which category is the biggest earner and which is the dead weight, as well as how income patterns change from year to year.

TRUE STORY

I had a client who sold both new and second-hand computer gear, as well as computer accessories. When he split up his income to monitor how much money he generated from each source, he was surprised at the pitiful amount second-hand sales produced. 'They're such a headache,' he said, 'and take up about 80 per cent of my time every week. I can't believe they bring in so little.' He watched the trends for a few more months and, subsequently, made the decision to axe the second-hand goods, a strategy that's worked really well for him.

The other thing to bear in mind when analysing sales is how the split of your sales reflects your overall business strategy. For example, maybe you run a music school and your long-term business strategy is to develop online music lessons with high-profile teachers. You certainly want to separate this income category in your Profit & Loss reports so you can monitor the growth in this area.

Counting the costs

Whatever kind of business you have, you probably have some expenses that directly relate to sales (in accounting jargon, these are *variable expenses* and are called *cost of sales* accounts). The idea is that when sales go up, cost of sales goes up, and when sales go down, cost of sales goes down.

MONEY STUFF

Think about your business and figure out which expenses are truly cost of sales accounts. Expenses that *aren't* cost of sales accounts are *fixed expenses*, and include things such as accounting fees, bank fees, computer gear, depreciation, electricity, interest, motor vehicle, rent, stationery and telephone. These business expenses don't change much from month to month, regardless of whether your sales go up or down.

Expenses that *are* cost of sales vary, depending on what type of business you're running. Here are a few examples to help you figure out what's what:

- **Service businesses:** If you run a service business, you may not have any cost of sales accounts, because you're not actually producing or selling anything except your time. However, if you employ staff or contractors to deliver the service — maybe you run a kids' party business and you employ other entertainers — these payments count as cost of sales. Everything else gets lumped together under expenses.
- **Manufacturing companies:** Cost of sales includes things such as raw materials, electricity used in the manufacturing process, production labour and factory rental. Expenses are things such as accounting fees and telephone.
- **Real estate agents:** Typical cost of sales includes advertising, agent commissions and signage. Expenses are things such as accounting fees, motor vehicle costs and telephone bills.
- **Retailers:** Cost of sales accounts are the goods that retailers buy to sell again, usually called purchases.
- **Tradespeople:** Cost of sales includes materials and subcontract labour, while typical expenses include advertising, phone bills and tools.

For more on fixed and variable costs, and how they affect your gross and net profit, refer to Chapter 7.

Weighing up your expenses

Grab your Profit & Loss reports for the last few months and scan them. Highlight your five highest expenses (usually items such as wages, rent, interest and advertising). Write these expenses down and total them up. My bet is that these five expenses combined probably make up around 75 per cent, or more, of your total outgoings.

REMEMBER

Think about how you could analyse these expenses in more detail. For example, maybe you could split wages into service staff and admin staff, or maybe you could split cost of materials into fabrics and accessories. Create separate accounts to enable you to monitor these expenses in a little more detail in your Profit & Loss. This will help with expenses control and future budgeting.

MONEY STUFF

I also like to separate any expenses from which I get a personal benefit of some kind. For example, it's good to separate your own motor vehicle running costs from those of your employees, or your own wages and super from employee wages and super. This way, you can quickly add up the total benefit that you're getting out of the business, something that often gets a little hidden when first looking at financial statements. This technique also comes in useful when you want to sell your business, as I discuss in Chapter 11.

Taking a Snapshot with Your Balance Sheet

If your Profit & Loss report tells a story about what's going on in your business over any period of time, your Balance Sheet is a photograph that shows a candid snapshot of how much you own and how much you owe at any point in time. As Figure 9-2 shows, a Balance Sheet starts by listing assets (such as your bank account, stock on hand, furniture and computer equipment), and then moves to liabilities (credit cards, supplier accounts, loans and the like). The bottom line finishes with a flourish, calculating the difference between your assets and liabilities — a figure that represents your stake in the business and that's often described as your *equity*.

More than anything else, your Balance Sheet is the report that shows the value of your assets, your stake in the business, the efficiency of your stock and customer management, and much more.

Realism City Balance Sheet as at June 30

Current Assets	**$**
Cheque Account	14,306
Petty Cash	100
Trade Debtors	23,500
Non-Current Assets	
Plant & Equipment — at cost	12,500
Plant & Equipment — Acc. Depreciation	(4,000)
Total Assets	**46,406**
Liabilities	
Trade Creditors	13,832
GST Paid	(2,562)
GST Collected	6,254
Visa Card	1,800
Bank Loan	22,000
Total Liabilities	**41,324**
Net Assets	**5,082**
Equity	
Retained Earnings previous years	12,250
Less: Drawings this year	(14,750)
Current Profit this year	7,582
Total Equity	**5,082**

FIGURE 9-2: A Balance Sheet shows where your business is at.

Understanding the fine print

Like your Profit & Loss report, read every little bit on your Balance Sheet and make sure it makes sense. You may want to go over the nitty-gritty of your own report with your accountant but, in the meantime, here are a few comments to get you going:

REMEMBER

MONEY STUFF

- Your business bank account appears as an asset unless you have an overdraft, in which case the account shows up as a liability.
- *Trade debtors* is a fancy accountant term meaning money that customers owe you. Keep an eye on how much you're owed, making sure it doesn't get out of hand.
- On a more solemn note, *trade creditors* means money you owe to suppliers. (Hopefully this figure isn't too high.)

- *Accumulated depreciation* is yet another weird expression, meaning the amount your accountant has already claimed back on assets that you paid good money for, but for which you were unable to claim a deduction straightaway.
- GST Paid on Purchases either appears as an asset or as a minus liability because this GST is an amount the government owes *you* (yippee!). However, some accounting software doesn't distinguish between GST Collected on Sales and GST Paid on Purchases, instead only showing a combined account called Tax Payable.
- Hire purchase accounts show up in a weird and tortuous way that only accountants understand. However, as long as hire purchase loans appear in the liability section, they're probably okay.

Appreciating your net worth (someone has to, after all)

I often get asked about the *equity* section of a Balance Sheet, because it can be a little bewildering at first. Here is my two-minute explanation of how equity all works: Imagine you pitch up in the desert with two mates, Bruce and Wayne. You have ten bucks in your pocket when you arrive; after a fabulous game of poker, you still have ten bucks but you owe Bruce two dollars and Wayne owes you three dollars. You're one dollar ahead! The state of play now is

Cash	$10	Creditors	$2
Debtors	$3		
Total assets	**$13**	**Total Liabilities**	**$2**
Your net worth = Assets *minus* Liabilities = $11			

Can you see how the idea of equity works? You add up all your assets (including things such as cash, customer accounts owing and motor vehicles), and then add up all your liabilities (stuff such as credit cards, supplier accounts outstanding and loans). Subtract total liabilities from total assets and you arrive at your equity in the business — a figure sometimes also described as *net worth*.

The equity section of your Balance Sheet always equals the difference between your assets and liabilities. If total equity is a positive figure, your business has made a profit over time and you've left some of this profit in the business (either that or you've put your own capital into the business). If total equity is a minus figure, your business has made a loss over time *or* you've taken out more than you've put in (or a combination of both).

Why Profit Doesn't Always Mean Cash

I can't believe how often clients ask, 'Veechi, my reports say I'm making fistfuls of cash, but how come there's nothing in the bank?' Similarly, I occasionally witness clients who are wallowing in cash and living the high life, even though their Profit & Loss reports are decidedly gloomy.

REMEMBER

The long and short of it all — profit doesn't equal cash and cash doesn't equal profit.

Gazing into the deep, black hole

Why is it that your Profit & Loss reports say you're doing well but you have no cash anywhere to be seen? I set out a few possible explanations here:

MONEY STUFF

- **You've been paying tax:** A tricky habit to avoid (do tell me if you discover how), but the truth is that as soon as you make any profit, you have to pay tax. (Tax payments don't usually show up in Profit & Loss reports for sole traders or partnerships because, cruelly enough, they're not a tax-deductible expense and count as owner's drawings.)
- **You've bought new equipment or a car:** If you buy new equipment or motor vehicles, you or your bookkeeper have probably allocated this purchase to an asset account, not an expense account. This is the correct treatment, but the upshot is that the purchase doesn't appear as an expense in your Profit & Loss report, explaining why you can be short on cash even if your profitability looks rosy.
- **You have teenagers:** The most merciless financial cash drain on any individual. (Just kiddin'.)

- **You repaid a loan:** Loan repayments don't usually show up as expenses, meaning that loan repayments gobble up cash but don't affect your profit.
- **You're owed more than you were before:** If you bill a customer in April, your Profit & Loss reports show this income in April, even though you may not actually receive the cash until weeks or months later. Therefore, if customers owe you more now in total than they did at the beginning of the period for which you're reporting, this difference has sucked up your cash.

Looking through rose-coloured spectacles

It may be easy to grasp why a business may not have any cash even though the business is turning a profit. However, what about the opposite scenario, where a business is rolling in cash but the Profit & Loss reports look unfavourable? In many ways, this situation is even worse, because you can all too easily get lulled into a false sense of security and spend beyond your means.

Here are some reasons cash might be rosy but your profit grim:

REMEMBER

- **You receive a loan:** Loans are both a blessing and a curse. When you receive a loan, the sudden influx of cash can burn a hole in the thickest of pockets.
- **Your creditors are building up:** You can actually get by for quite a while making a loss but staying afloat, simply by running up outstanding accounts. If you start to stretch out suppliers to 60, 90 or even 120 days, you not only generate a fair amount of bad feeling, but wads of cash also.
- **You're running stock down:** If your stock levels go down, you have more cash available. Simple as that.

Budgeting for Profits

One of the most powerful techniques for increased profitability is to create a budget. This budget may take several iterations before you arrive at a plan for the months ahead that is both realistic and delivers the profits you require. With this budget in place, your project is to stick to it as closely as possible.

Understanding the terminology

People tend to use the words ‘budget’, ‘projection’ and ‘cashflow’ synonymously, but there are subtle differences.

In the planning stage of your business, you usually start with a *projection*. (I talk lots about profit projections in Chapters 6 and 7.) A projection is less a statement of intent, and more a statement of what might be possible. I often use projections to experiment with ‘what-if?’ scenarios, looking at what would happen to my profits if I were to take on a new product, add an extra employee, or shift the focus of my business in some way. Projections often extend forward three or five years into the future.

Later on, if I’m confident that my business model is viable, I can take these projections and use them to create budgets. Rather than being a document that experiments with different scenarios, a *budget* outlines expectations and responsibilities, setting sales targets and expense limits. In larger businesses, for example, part of the responsibility for each manager is to meet agreed sales budgets, and ensure spending doesn’t exceed allocated expense budgets.

TIP

Although you may find it easiest to draft your budgets using a spreadsheet, I suggest you take the time to add your final budget figures into your accounting software. This way, it’s easy to compare actual results against budget figures every month.

A *cashflow* is a different report again, and looks at the actual cash flowing in and out of a business. For example, if you receive a $20,000 loan from the bank, this appears on your Cashflow Projection report but doesn’t show on your budget or your Profit & Loss Projection. (Why not? Because a loan doesn’t count as income.)

Recognising relationships

When reviewing your budget, take time to consider whether any income or expense categories are directly related to one another. For example, purchases, commissions and freight usually go up or down in direct proportion to monthly sales, and superannuation goes up and down in tune with wages.

TIP

If using a spreadsheet, the trick is to use formulas so that related amounts calculate automatically. So, for example, if you raise your sales forecasts, purchases correspondingly go up; if you change wages, superannuation also changes.

Understanding the psychology of budgets

Forget astrology, numerology, psychometric testing and aura reading. Instead, observe your colleagues as they create their first budget. The optimists pump up sales beyond reason, the pessimists warn against enormous expenses and creative types scrawl a few lines and give up.

I don't know what kind of person you are, but here are some general tips for creating a budget that works easily and ends up somewhere close to the truth:

REMEMBER

- **Allow extra for unforeseen expenses:** Things always cost more than you think.
- **Compare budgets against actuals on a regular basis:** Comparing your hopes and aspirations against the grim truths of real life, as I do in Figure 9-3, shows up your delusions in a flash.
- **Consider carefully the timing of irregular payments:** Things to remember include quarterly electricity bills, months with five pay weeks and annual insurance premiums.
- **If you budget for higher sales for this year than last year, make sure you've got whatever it takes to reach that goal:** For example, if you decide to increase the sales budget to $70,000 (compared with $62,000 last year for that month), put changes in place that make this higher budget possible, such as new stock lines, new marketing strategies, or more staff training.
- **Involve different staff members:** The more input, the more realistic the budget can be.

AHEAD OF THE PACK

- **Have one sales budget for sales staff, and another for finance:** Low sales budgets are hardly going to act as motivators for your sales team. So keep two sets of sales budgets: One for sales staff and another for yourself or your finance manager. The lower set of sales budgets are what you should use in order to set your expense budget for the year.

- **Split sales budgets into regions, customers, territories or salespeople:** Because sales budgets are so crucial, split them up as much as possible. For example, if you have a team of salespeople, ask each one to set a sales budget, and provide coaching and support to help each team member achieve this.

Realism City Budgets versus Actuals for January			
	Jan Budget	**Jan Actual**	**Variance**
Sales — Clothing	34,500	32,000	–2,500
Sales — Jewellery	23,400	25,000	1,600
Sales — Giftware	6,700	6,200	–500
Total Income	64,600	63,200	–1,400
Purchases — Stock	35,530	36,024	494
Gross Profit	29,070	27,176	–1,894
Advertising	1,200	1,100	–100
Bank Charges	75	60	–15
Electricity/Gas	350	370	20
Motor Vehicle	850	963	113
Office Rental	3,600	3,600	0
Postage & Stationery	850	250	–600
Salaries/Wages	4,800	5,462	662
Superannuation	456	519	63
Total Expenses	12,181	12,324	143
Budgeted Profit	**16,889**	**14,852**	**–2,037**

FIGURE 9-3: Keep budgets real by comparing against actual results.

Looking at Cashflow

As I mention earlier in this chapter, cashflows make projections about cash in and cash out, and how much money you'll have in the bank at the end of each month. For very small businesses, cashflow projections are usually very similar to profit projections and/or budgets, but for larger businesses, especially those with large stock holdings, seasonal sales, slow-paying customers or extended credit from suppliers, the bottom line of a cashflow can be very different from the bottom line of a budget for the same period.

For an example, compare the budget in Figure 9-3 with the cash-flow in Figure 9-4. Spot the differences:

- The budget shows sales, whereas the cashflow shows receipts from sales. (If you offer credit to customers, a bumper sales month doesn't necessarily result in a bumper month in terms of cash. A big sales month may actually eat up your cash because you have to pay for additional stock, and you could have to wait up to 60 or 90 days till the cash benefit of those sales comes through.)
- The budget shows figures before GST (because you never include GST in Profit & Loss results), whereas the cashflow shows figures including GST, including the quarterly tax payment (this payment may also be monthly or bi-monthly, depending on your arrangements).
- The cashflow includes incomings from loans (in Figure 9-4 this is called 'Receipt of loan from Bank').

Realism City Cashflow for January to June	Jan	Feb	Mar	Apr	May	Jun	Total
Cash Inflow including GST							
Receipts from Clothing Sales	34,155	37,656	38,748	41,499	37,453	38,427	227,937
Receipts from Jewellery Sales	23,166	25,541	26,281	28,147	25,403	26,063	154,601
Receipts from Giftware Sales	6,633	7,313	7,525	8,059	7,273	7,463	44,266
Total Receipts from Sales	63,954	70,509	72,554	77,705	70,129	71,952	426,804
Plus: Receipt of loan from Bank	–	12,000	–	–	–	–	12,000
Total Cash Inflow (incl GST)	63,954	82,509	72,554	77,705	70,129	71,952	438,804
Cash Outflow including GST							
Payments to suppliers for stock	42,000	39,083	41,037	43,089	45,243	42,981	253,434
Advertising	1,320	1,320	1,320	1,375	6,600	1,485	13,420
Bank Charges	75	75	75	75	75	75	450
Electricity/Gas	–	–	1,155	–	–	1,050	2,205
Loan repayments	5,500	5,950	5,950	5,950	5,950	5,950	35,250
Motor Vehicle	935	935	935	935	935	935	5,610
New Computer System	–	–	19,000	–	–	–	19,000
Postage & Stationery	935	935	935	935	935	935	5,610
Rent	3,960	3,960	3,960	3,960	3,960	3,960	23,760
Net Wages	3,840	4,160	3,760	5,760	3,520	5,760	26,800
Superannuation	900	–	–	1,117	–	–	2,546
Total Cash Out (inc GST)	59,465	56,418	78,127	63,196	67,218	63,131	388,085
Payment of GST and PAYG	7,200			6,876			14,076
Starting Cash Balance	**1,500**	– 1,211	24,880	19,307	26,941	29,851	
Cash In Less Cash Out less GST	– 2,711	26,091	– 5,573	7,634	2,911	8,821	
Closing Cash Balance	**– 1,211**	**24,880**	**19,307**	**26,941**	**29,851**	**38,673**	

FIGURE 9-4: A sample cashflow report.

- The budget shows purchases of stock, whereas the cashflow shows payments made to suppliers.
- The cashflow includes loan repayments, the budget doesn't.
- The cashflow shows wages *before* employee tax, but the budget shows wages *including* employee tax. However, the cashflow shows the payment of employee tax going out every quarter.
- The cashflow includes the purchase of capital equipment (notice the new computer system purchased in March), but the budget doesn't.
- If you're a sole trader or partnership, the budget wouldn't show personal drawings, but the cashflow would.
- The cashflow includes three extra lines at the bottom: Starting Cash Balance, Cash In less Cash Out less GST and Closing Cash Balance.

REMEMBER

The really neat thing about cashflows is that you make predictions about the state of your bank balance and plan accordingly. For example, in Figure 9-4, note that Realism City is going to have a tight month in January, due to big supplier payments and payment of GST, but that things brighten up by the end of June. Given this gloomy prediction, Realism City may be wise to ease back on spending as much as possible during January.

REMEMBER

The easiest way to create a Cashflow Projection is to use a spreadsheet program or specialised business-planning software. In my example, I opened my budget spreadsheet and saved it under a different name. Then I made all the necessary changes, adding several lines to modify the budget so it became a Cashflow Projection.

I'd be kidding you if I said that cashflows are always as simple as I make them out to be. In reality, cashflow projections often require several worksheets, all of which interconnect with one another. For example, a cashflow may have one worksheet for sales budgets, another for predicting when customers are likely to pay, another forecasting when suppliers are to get paid and a prediction of stock levels. If your cashflow gets this complex, you probably want to get some help from an accountant to create your first template.

REMEMBER

Don't forget to allow for company tax bills when making cashflow projections, for as soon as your business starts making a profit, you're going to be hit with tax bills.

IN THIS CHAPTER

» Using technology and systems to save labour

» Scrutinising key expenses, and implementing efficient accounting

» Finding ways to get customers to buy more

» Maximising what's working, and getting rid of what isn't

» Being prepared to start anew

Chapter 10
Ten (Almost!) Tips for Improving Your Bottom Line

Do you feel sometimes that each day is one step forward, one step back? How can you find that extra little bit of profit in your business?

In this chapter, I share a bundle of tips for how to earn yourself that extra edge and improve your bottom line.

Evaluate Every Workflow

Take the time to examine every process that takes place regularly in your business, and see if you can work smarter, rather than harder. Every business is so different that I can't suggest where you might save time or labour, but here are some ideas that may spark inspiration:

- A dentist offers patients the ability to book their appointments online, saving receptionist staff valuable hours.
- An online clothes retailer syncs their eBay store with their accounting system, so that invoices and packing slips are generated automatically.
- An air-conditioning company uses scheduling software to group jobs geographically, saving on petrol and travel time.
- A restaurant shifts to online ordering and bulk delivery of groceries, saving time and buying goods cheaper.
- An IT company employs virtual assistants to reply to routine support calls, saving on staffing costs and providing 24-hour service.

Have a good think about your business, and see if you can identify areas where you could implement systems that make things run more efficiently.

Scrutinise Expenses

If you've been in business for a while, you might be habituated to a certain level of expenses. However, it always pays to review all your business expenses — after all, every time you manage to shave some dollars off an expense, you manage to reduce the break-even point for your business (a topic I explore more in Chapter 8).

Here are some suggestions:

MONEY STUFF

- **Attempt to shift expenses from fixed to variable, wherever possible:** For example, see if you can pay suppliers and salespeople on a commissions or royalty basis calculated on sales, as opposed to paying fixed fees. Such flexibility protects your cashflow and is vital for any unproven business initiatives.
- **Consolidate your debts:** If you have lots of credit cards, reduce interest expense and monthly repayments by asking

your bank to consolidate the debt into a single loan or single credit card with lower interest.

- **For every fixed expense, ask whether this expense adds value for the customer:** For example, if you're paying high warehouse storage fees for a whole heap of obsolete stock that customers aren't buying, now's the time to cut your losses and have a fire sale.

REMEMBER

- **Identify the five highest expenses in your Profit & Loss:** For each of these expenses, see if you can find ways to reduce them by 10 to 20 per cent. Perhaps an impossible challenge, but one that's worth a try!
- **Review anything that's on a plan:** The usual culprits are mobile phone plans, internet plans, electricity and gas. If your current contract period has expired, get on the phone and start negotiating a new plan with bigger discounts.
- **Review your motor vehicles:** Sometimes the problem is that a business spends way too much on expensive vehicles they don't really need; other times, businesses insist on sticking with ancient rustbuckets with hideous maintenance bills.
- **Scrutinise your wages bill:** Although you may not be able to afford to get rid of any employees who form a vital part of your business income, wages are often the biggest expense for a business. Some things to look for include unnecessary overtime (employ casuals instead), weekends and penalty loadings when you could work yourself, and using skilled labour for unskilled tasks.
- **See if you can reduce your rent:** You may not have a choice about your rent, but do at least consider how you may reduce this expense. Maybe you can sublet some of your premises or even negotiate with the landlord to reduce the rent. Or, if you're not in retail, maybe you can move to smaller or less expensive premises.

REMEMBER

- **Unsubscribe, unsubscribe:** You know the ones. Everyone from your cloud backups to VOIP, from Netflix to Dropbox. Take the time to unsubscribe from anything that doesn't generate value for your business.

Get Good Accounting Systems

Almost every tactic to increase profit that I recommend in this book requires that you know what's going on in your business. Without decent accounting systems, such knowledge is impossible.

You can find a number of good accounting solutions suitable for Australia's business environment, with top contenders including MYOB, Reckon, QuickBooks and Xero. Whatever solution you choose, do ensure that the software can operate from a web browser, so that you can access your accounts wherever you are, and from whatever device you happen to be using.

In addition, ensure the software has bank feed features, and take the time to enable these features. *Bank feeds* refers to the process where your accounting software connects to your bank every night and downloads a summary of every transaction for that day. Sounds boring, but not so. The outcome for you is that your transactions appear automatically in your accounts (the date, the amount, who was paid and so on), without you or a bookkeeper having to do a thing.

TIP

Bank feeds work together with bank rules. *Bank rules* are the process whereby you can create 'rules' so that transactions are coded automatically to the correct accounts. In other words, every time you log into your accounts, all your transactions are already entered. All you have to do is review how these transactions have been coded, and click OK to approve them. In the blink of an eye, you can generate a Profit & Loss report showing you exactly where your business stands.

Become the Expert

Sometimes I come across business owners who are so good at what they do that they find it hard to employ others who can deliver the service with the same flair or to the same standard.

AHEAD OF THE PACK

This level of expertise often points to the opportunity for this person to create a side hustle delivering training or coaching in their industry. You might be a consultant, a salesperson, an IT engineer or a naturopath, but if you have a knack that others don't, you may be able to earn some very decent money coaching others in the skills you've developed.

Invite Customers to Buy More

Sounds so obvious, but it's surprising how many businesses overlook this simple step. The idea is that for every single sale you make, you ask yourself, 'How can I get this transaction to be for a larger dollar amount?'

Techniques for customers to buy more include reselling, upselling and cross-selling.

TIP

- *Reselling* is when you find a genuine way for your customers to purchase your products or services repeatedly. This might not be the entire purchase, but could be an ongoing maintenance program, a membership subscription, a rewards card for regular purchases, or even auto-renewals on customer credit cards.
- *Upselling* is when you encourage customers to increase the amount they spend on each transaction. Examples include offering a premium service or brand, selling extended warranties, charging extra for express delivery, or selling products to extend the life of an item.
- *Cross-selling* entails finding ways to persuade customers to buy more with each purchase. Examples include bundling additional services, offering sparkling water to restaurant diners, offering gift-wrapping (for a fee), selling matching bedside tables with each bed sold, or simply the classic question: 'Would you like fries with that?'

Take some time out to brainstorm how you might use any one of these three techniques (or perhaps all three!) to generate some extra business profits.

Focus on What Works

One trick to boosting profitability is to identify your most profitable products and services, along with your best customers, niches or channels. Examine these sales, and if you consider that any of these areas have a long-term future or indicate potential for expansion, focus your attention accordingly.

For example, perhaps a florist can see that weddings clearly generate much more profit than daily sales from the shopfront. While maintaining the shopfront is likely necessary for other reasons, it probably makes good sense for the florist to focus the bulk of their marketing activities towards attracting more bookings for weddings.

Similarly, take the time to identify the areas of your business that drag you down. One accounting firm I worked with actually had a policy to consciously divest themselves of 5 per cent of their clients each year, identifying the clients who were particularly difficult, demanding or risky to deal with.

TRUE STORY

A client of mine builds custom kitchens for a living but he also used to sell tiles from his factory unit. When he did the numbers, he found the tile sales generated very little profit and required an extra staff member. The decision was a no-brainer. He got rid of the tile sales, sublet the factory space that was freed up, and got rid of the extra staff member.

Be Prepared to Think Afresh

Do you have a sneaking suspicion that your business model is actually a bit of a dud? If things have been slowly sliding backwards for years, or they simply never got off the ground in the first place (maybe the beachwear shop in the Snowy Mountains was a crazy idea after all), then the time has come to reassess your idea. As the Spanish say, ‘There’s no use trying to plough the sea with a tractor.’

I don’t necessarily mean closing your business completely (after all, you probably have lots of lovely tax losses to take advantage of), but I am talking about the need to think laterally and reinvent yourself. Maybe you need a new business partner, maybe you need to move location or maybe you need to do something totally different? A good starting point is to make your way back to Chapter 2 and re-evaluate your business strategy, in particular looking at your competitive advantage and point of difference.

Another possibility is to consider selling your business, particularly if your business carries a substantial amount of debt such as business loans, leases or shareholder loans. If you can find a purchaser who can run your business without the same level of debt, your business might be a viable going concern.

Stay on Top of Debtors

If your business offers credit to customers, one of the most important aspects of managing your profitability and cashflow is to monitor overdue accounts and chase payments when required.

If you don't have an outgoing personality or you're not a naturally assertive person, this process can be somewhat gruelling. This reticence quickly turns into a negative cycle, because the longer you leave a debt before you chase it, the more likely it is that the debtor won't pay. The secret to getting paid is to have clear credit terms and make contact with customers the moment they go beyond these.

MONEY STUFF

If you have trouble getting motivated about the idea of debt collection, think of it this way: Imagine your monthly sales are $30,000 and customers pay on average in 60 days. If you can reduce this average from 60 days to 45 days, you generate an extra $15,000 of working capital for your business, interest-free!

IN THIS CHAPTER

» Preparing for sale, years ahead

» Identifying the secret weapon that makes your business worth five times more

» Compiling the ultimate sales document

» Doing the buyers' job for them: Due diligence and more

» Finding a buyer

Chapter 11
Ten Tips for Selling Your Business

In many ways, the ideas that I've been sharing throughout this book for building extra profitability all contribute to you maximising the potential sale value of your business.

Probably one of the most important concepts is ensuring that your business can run separately from you, the owner. By planning to build a business that still generates revenue even when you're not there, you're creating an entity that has a value in its own right.

Preparation is the other key to securing a good price for your business. Plan to sell when the timing is best not just for yourself but also for your industry and the current economic climate. You don't want to be forced into a sale, or simply to sell your business because someone fronts up and offers a half-decent price. Instead, plan your exit with a sense of flair, so you can walk away with money in your pocket and a smile on your face.

Start with a Game Plan

Always try to have an exit plan simmering away, even if you don't plan to sell in the immediate future. Ask yourself: If I were to sell this business today, what could I get for it? When would be the best time to sell? Who would potential buyers be? Can this business run independently of me? What assets or business systems do I have to sell?

AHEAD OF THE PACK

If possible, try to create a formula with your business that you (or someone else) can replicate again and again, so that your business idea can expand. For more on this way of thinking, see if you can get your hands on a copy of *The E-Myth* by Michael Gerber, which explores practical models for turning a simple business idea into resaleable assets.

Prepare Well in Advance

One of the keys to getting a good price for your business is being able to choose the time when your business is at its peak. Too many business owners get forced into selling due to ill-health, personal circumstances or because they're struggling to survive. You can't hope to get a good price in this situation. Rather, aim to time the sale to suit yourself, doing the groundwork at least three years (yep, I said years, not months) in advance. If a buyer can tell that you've been planning this transition for quite some time and that you have well-kept financial records, proper policies and procedures and comprehensive customer records, then you're going to maximise your sale value.

The first step, which is only possible if you plan in advance, is to declare every cent of cash takings. (Sure, you could choose to keep a 'black book' where you record cash takings but, hey, if you offer visible proof that you're happy to be dishonest about your tax, how can a prospective buyer trust you not to be dishonest about other things too?)

TRUE STORY

The next step is to improve your net profit every which way you can. Remember, for every dollar you increase your bottom line by, you may be able to realise up to five times that amount in the increased value of your business. I knew a husband-and-wife team who ran a nursery business with a turnover of $600,000 and average net profits of $50,000 a year. As part of preparing to sell, they bumped up prices by 10 per cent. Sales only dropped a little but, even so, they immediately made an extra profit of $40,000, increasing average profits to $90,000 a year. The result was an instant increase in value of their business of about $80,000.

Your business may not be so fortunate that it can sustain a price increase of 10 per cent, especially in the current economic climate. However, I bet you can find a few ways to increase net profits in the short term:

- Keep your focus on the main game by avoiding new projects and products.
- Clamp down on any personal expenses that you filter through the business.
- Look for ways to save money, such as subletting unused factory space or renegotiating telephone contracts.
- Get rid of old equipment and tools.
- Go through stock holdings item by item, selling old stock for whatever you can get for it. (Even selling stock for cost is better than giving it away for nothing because the new owner isn't prepared to take it on.)
- Ask staff, contractors and clients for suggestions and ideas about improving customer service, increasing revenue and reducing costs.

REMEMBER

Although I recommend you pull back on expenses where you can, don't cut corners on things that count towards first impressions. Keep your premises looking clean and free of clutter, with new paint and well-maintained equipment.

Give Your Financials a Make-Over

Any prospective buyer is going to want to have a stickybeak at your Profit & Loss reports, Balance Sheet and Aged Receivables report. (For more information about these reports, and what info they include, mosey back to Chapter 9.)

You're probably thinking, *All I have to do is click a few buttons in my accounting software and print the reports. No sweat.* Not quite. Your job, in order to get the best price possible, is to make sure these financial reports are in marvellous shape. (***Note:*** I'm talking financial reports here, not financial results. For more about financial results, refer to the preceding section.)

First, go through your Profit & Loss reports and identify any irregular expenses. Maybe repairs were high one year because you renovated the office. Maybe you had big workers comp expenses because of an employee claim, or maybe you relocated your warehouse. If possible, separate these expenses and show them below your Net Profit figure, under a heading called Abnormal Expenses.

TIP

Give your Balance Sheet a tidy-up too. Check the value of land, equipment and furnishings: If values appear too low, ask your accountant about the possibility of adjusting these figures to show what stuff is really worth. If you can see any accounts on your Balance Sheet that shouldn't be there (such as old loans or personal credit card debts), ask your accountant to get rid of them.

With your Aged Receivables report, remove any debts where you know you have little chance of getting paid. Then get busy chasing any other debts that are overdue.

Get a Professional Valuation

Almost everyone who tries to sell their business has an unrealistic expectation of how much their business is worth and what the market might be prepared to pay.

Many business owners have spent years investing everything they have into building their business. They don't think of the value of the business in terms of what somebody might be prepared to pay, but rather in terms of what they think they deserve. Others decide the value of their business by thinking about how much they need in order to retire, and then reverse engineer the price from there.

If you search on the internet, you'll quickly find different methods for calculating the value of your business. The most common method is to calculate your average earnings before income tax and depreciation (a figure known by the snappy acronym of EBITDA) and then multiply this figure by anywhere between

1.5 and 6, depending on the industry. However, even this conventional method can be very subjective, if only due to the choice of multiplier.

AHEAD OF THE PACK

Instead of trying to value your business yourself, I recommend you seek out a broker who specialises in selling businesses. A good broker should understand different valuation methods, industry standards and current market trends, all of which contribute to a fair price. You will need to pay a fee in order to secure a full valuation, but I reckon this is money well spent.

Go for the Max

One way to maximise the value of your business is to identify a strategic advantage that you own and which some other business — usually one that's bigger than your own — can lever to great benefit. Sometimes this strategic advantage may be worth very little in your eyes but can be worth a great deal in the eyes of a buyer. (***Note:*** This strategic advantage method of valuing a business is often overlooked by brokers who tend to rely on more conventional methods.)

TRUE STORY

Some examples of strategic advantage include:

- **Customer relationships:** A client of mine managed to get his product into a national retail chain and, over the years, built a great relationship with this chain. My client sold his business, at a substantial premium, to a larger player in the same industry who was having problems getting its product accepted by this chain.
- **Software design:** Several years ago, another client of mine developed some clever software — at great expense and with many teething problems — that managed medical appointment bookings online. A much larger medical company, with branches in every state, purchased his business primarily to get ownership rights for the software, which they instantly implemented nationally, resulting in substantial annual cost savings for them.

» **Exclusive supplier deals:** Another client secured exclusive dealership rights to import a certain product from China. My client then sold the business, along with the distribution rights, to a much bigger competitor with outlets all around Australia. Although my client's business was suffering at the time, sustaining losses month after month, the business was sold for a handsome sum, simply because the competitor was so eager to get hold of those distribution rights.

Can you think of some strategic advantage your business has that might be worth more to somebody else than it is to you?

Plan for a Few Bills

Regardless of whether you think you're gonna make a motza or sell your business for a song, speak to your accountant before putting your business on the market.

MONEY STUFF

The main expense to be aware of is capital gains tax, which in theory applies for any profit you make on the sale of your business. For example, if you start a business from scratch and, then, five years later you sell the goodwill for $50,000, you may be liable for capital gains tax on that $50,000. You may also have to pay GST on any assets that you sell.

With a bit of foresight, however, you may be able to minimise this tax, maybe by rolling the money into another business, putting funds into superannuation, or selling off shares. You may also be able to reduce or offset your tax by selling shares in your business; for example, by selling 33 per cent each year for three years. Each of these strategies demands careful planning and professional advice.

On the flip side, if you think you're going to sell your business at a loss, a bit of tax planning in advance is still wise. For example, you may be able to cut back on next year's tax bill by timing the sale of your business to offset capital gains on other assets or income from a regular job.

MONEY STUFF

Last, don’t underestimate how much selling a business costs, not just in taxation but in other costs as well. Typical costs include legal fees for drawing up contracts, valuation fees for property and for stock, lease transfer fees, early loan payout penalties and accounting fees. You may also have to pay out trade creditors and any staff entitlements for holiday or long service leave.

Woo the Buyer

Your next job is to woo the buyer. Not with flowers, wine and sweet nothings (although this strategy may be a winner, depending on the buyer) but, rather, with an impressive document that presents your vital statistics in a seductive manner. You can write this document yourself, hire a writer or appoint a business broker to assist you.

Here’s what to include:

- **The story of your business:** Write a description of your business, when it started, what you sell and who your customers are. If you have a recent business plan, some of this info is probably already sitting pretty, ready to go.
- **Current battle tactics:** Share a short synopsis of your marketing plan and marketing strategies.
- **Lease commitments:** Include a description of your business premises, how much rent you pay each month, and the terms of your current lease. Remember that most commercial leases require your landlord to agree before you can reassign somebody else to the lease. If the lease is close to expiring, the landlord may insist upon a new lease.

MONEY STUFF

- **The main game:** Provide a financial summary for the past three years, including total sales, gross profit and net profit. Highlight any positive trends such as growth in sales of 10 per cent annually.
- **A people picture:** Include a summary of all employees, how much they earn and any special skills they have.
- **Big deals on the go:** Do you have any major contracts with customers or suppliers? Share the details.

AHEAD OF THE PACK

- **Dreams in the making:** Deal-making is exciting stuff, and a dream may captivate a buyer more than reality ever can. Mention any ideas you have for expansion, such as new locations, online sales or new product lines.
- **Why you're special:** Have you won any awards or received local business citations? Or do you have a collection of customer testimonials?
- **The reason you're out of here:** Any buyer wants to know why you're selling, so be honest and to the point.
- **The bottom line:** What does your asking price include? Obviously, your price includes goodwill, but what about assets such as stock or debtors, or liabilities such as unpaid employee leave or supplier accounts?

REMEMBER

I suggest you have a legally binding non-disclosure agreement (NDA) signed and in place before sharing intellectual property or detailed financial records with any potential buyer. This legal agreement outlines the confidential information, knowledge or materials that you wish to share, and places an obligation upon any prospective buyers not to disclose such information.

Do Due Diligence in Advance

When buyers are interested in purchasing a business and have started the formal negotiation process, they go through a process called *due diligence*. Due diligence involves making sure every single piece of paperwork is in order. Most sellers wait for the buyer to ask the questions, and then do the running around to provide the information. Thing is, you always end up being one step behind the eight ball, and every time the buyer finds something that appears to be not quite right, the negotiation process, as well as valuable trust, gets eroded.

A smarter approach is for you to do the due diligence for the buyer and present everything as a single document. (I offer a simple checklist in Figure 11-1.) Put yourself in the buyer's shoes: If you were looking to buy this business, what would cause you to hesitate? The fewer problems that arise, the less chance to negotiate the price downwards, and the quicker the deal can go through.

Checklist for Preparing Your Business for Sale

- ❑ A contract for the sale of the business
- ❑ Profit & Loss reports for the last three years, along with tax returns
- ❑ Audit reports, if available
- ❑ Up-to-date Balance Sheet
- ❑ A list of what customers owe you, and a list of what you owe suppliers
- ❑ Proof of past sales (till rolls, invoice copies, contracts)
- ❑ A list of stock items held, including quantities, purchase dates, cost value and recommended sell price
- ❑ Proof of work-in-progress
- ❑ Employment contracts
- ❑ Copies of leases, both for premises and for equipment. (Oh yes, and make sure the lease is up to date.)
- ❑ Risk management plan and records of OHS compliance activities and fire safety inspection reports
- ❑ A register of staff training activities and copies of staff certificates
- ❑ Proof of software licences, and information about the ownership of any custom software applications
- ❑ A list of assets with current values, as well as a current depreciation schedule
- ❑ Any significant contracts held with customers or suppliers (if you have any agreements that aren't in writing, organise that now, too)
- ❑ Copies of insurance policies
- ❑ Copies of all outstanding quotations, including date of issue for each one
- ❑ Intellectual property register along with proof of intellectual property, such as copies of registered designs or trademarks, recipes or product patents
- ❑ Customer database information (make sure this info is up to date)
- ❑ A list of any customer deposits held, or supplier payments made in advance

FIGURE 11-1: Checklist for preparing your business for sale.

Be Straight Up with Employees

In the initial stages of preparing to sell your business, keep your plans under wraps. You don't want employees to get wind that you're looking to sell and start looking for work elsewhere.

Later on, when you decide to spread the news that you're up for sale, start by telling staff about your intentions. Present the news in a positive way, reassuring staff (if you can) that their jobs aren't on the line, and that you're going to be involved in the handover and the whole transition process.

If the new owners choose to retain existing employees when they take over, provide as much information as you can to the new owners, such as employee records, a history of all leave taken, and a summary of existing obligations including personal leave, annual leave and long service leave.

Alternatively, if the new owners do not intend to retain your employees, seek advice from Fair Work or your employer association regarding termination procedures, notice periods required and payouts of leave and other entitlements.

REMEMBER

One tricky area can be family employees. Sure, the new owners may be happy to employ your son or aunty or cousin-three-times-removed, especially if that person contributes valuable skills. However, the owner's unreliable son who currently gets a sweetheart deal with their employment is another matter. A good strategy (if those concerned are willing) is to get each family employee to sign two letters: The first letter being an Employment Contract agreeing to stay with the business and agreeing to certain conditions of employment; the second letter being a letter of resignation. The new owners then have the choice between which letter they accept, and whether they inherit family employees with the business, or not.

Spread the Word

Don't assume that the best approach is to advertise your business for sale, listing the business online or via the local real estate agent. By cutting straight to advertising, you risk losing your best prospects.

Instead, have a think about any employees, customers or suppliers who may be interested in purchasing your business. Never underestimate the power of word-of-mouth advertising. After all, these people know and trust you, and probably understand your industry. One of my clients sold his restaurant to a faithful customer who, when the idea of buying the restaurant was suggested to him, simply couldn't resist.

At the same time, consider whether any of your competitors may be interested in buying your business. Are you squirming at the very thought? Don't. Earlier in this chapter (refer to the section 'Go for the Max'), I talk about identifying and capitalising on any possible strategic advantage that you can. Competitors are often best placed to capitalise on a strategic advantage and, for that reason, may offer you a price you won't get anywhere else.

If you don't get any nibbles from people in your network, take the next step and advertise your business for sale. I can't recommend any particular method, because the best strategy depends on your business and the kind of money you're looking for. Traditional advertising media include your local real estate agent, a business broker or a notice up in the shop window. Increasingly, however, people find success listing their business for sale online, in one of the many online directories available.

Ask yourself: 'Who might want to buy my business?' If your business belongs to an industry with trade publications, try the classifieds in these publications (for example, a freight haulage business may find that advertising in trucking magazines attracts the right buyer).

REMEMBER

Throughout the sales process, be patient. In the same way that building up a business takes time, selling a business takes time too. Often, whichever side of the negotiating table has the most time gets the best deal. If you plan your sale well in advance, you have a much higher likelihood of achieving full value for your business than if you're time-pressured to sell. Hang out for the best deal and, hopefully, you can walk away from this period of your life with a deep sense of satisfaction.

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About the Author

Veechi Curtis is passionate about Australian business and the potential that people have to achieve financial independence and realise their dreams.

Born in Scotland, Veechi attended university in Australia, where she completed her undergraduate degree in Accountancy and a Masters in Business Administration. She has been a small business consultant for more than 20 years, training and mentoring hundreds of businesses over this time. She has written for many publications and has also been a columnist for *The Sydney Morning Herald*.

Running a business in theory is very different from running a business in practice. In *Planning a Profitable Business For Dummies*, Veechi draws on her experience of running her own business, as well as her experience serving as a director on the boards of several local business and community organisations.

Veechi is also the author of *Small Business For Dummies*, 6th Edition, *MYOB Software For Dummies*, 8th Edition, *Bookkeeping For Dummies*, 3rd Edition, and the international edition of *Creating a Business Plan For Dummies*.

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