BusinessPlus+ Newsletter

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INDEX

Issue – November 2022

Better Decision Making in a Volatile & Uncertain World

It quite apparent that the operating world has more uncertainty, risk and unknowns than have been experienced for a long time…and perhaps ever. Thus, making good decisions in this environment has become that much more difficult. So a review of some good decision-making approaches and background seems to make good sense.

Risk in Context

01	Certainty	It is just going to happen (100% probability, e.g. that if I drop this pen it will fall by the force of gravity)
02	Risk	We can precisely calculate the probabilities (e.g. casino games, slot machines, lottery)
03	Uncertainty	We cannot calculate the risks – we just don't have ways to get all the information (i.e. a very much real life scenario)

Countless business initiatives fail because business operators underestimate uncertainty and the chances of failure in their decision making —and instead move directly to action.

Decision Making Approaches

1. **Define** the problem
2. **Disaggregate** the problem – because a single problem or decision can have many elements
3. **Prioritise** the elements to address
4. Develop a **workplan** to tackle the elements of the problem (finding the data you will need)
5. **Analyse** the information you have uncovered
6. Decide and **synthesize** your decision
7. **Communicate** with clarity

Source: ***"Bulletproof Problem Solving: The One Skill that Changes Everything" McLean & Conn 2019 UK, Wiley***

However perhaps an even more simplified approach to making an important decision for SME business owner/operators, has the following key steps:

- **<u>Options:</u>** What are the top 3-5 (at most) alternatives/options to deciding this matter/issue for the business?
- **<u>Costs/Benefits:</u>** What are the comparative costs and benefits of each of these possible alternatives?
- **<u>Alignment:</u>** How well does each of the alternative options align to the company's core business objective, values, financial position, overall strategy and the owner's personal goals (as most pertinent to the matter at hand to be decided)?
- **<u>Evidence:</u>** What compelling supporting evidence is there to justify the selection of a preferred alternative? And
- **<u>Risk Management:</u>** What (in the worst-case scenario) could possibly go wrong if a particular alternative is chosen and what could be done to minimise or diminish those potential risks?

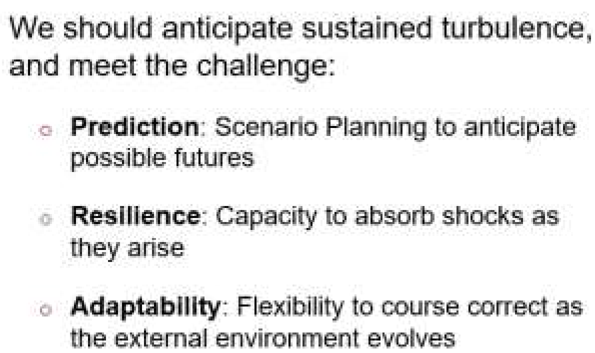
<u>Source:</u> ***"Six Thinking Hats" 2008 & "Thinking Course"*** 2006 Edward De Bono, UK Penguin Press

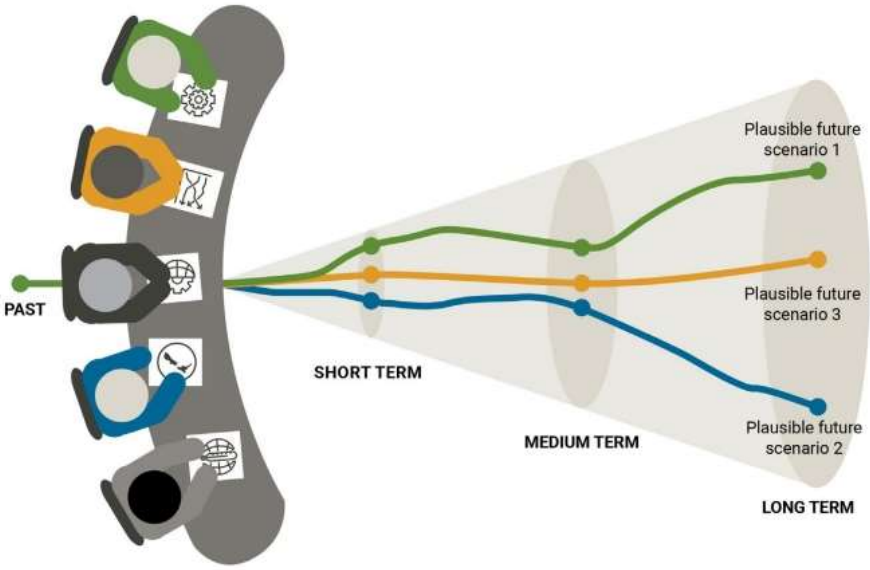
Sometimes to confront a decision impasse, it can be approached as shown in the diagram below:

<u>Source</u>: "***Vector Decision Making***" Perry 2018

Scenario Thinking & Decision Effectiveness

When scenario planning has worked well, it has proved enormously useful to a wide range of organisations as a tool for making decisions under uncertainty. First popularised by Shell in the early 1970s, the approach should be a natural complement to other ways of developing strategy— especially when executives are as concerned about geopolitical dynamics as many are today.





Scenarios can help you strategically anticipate and adapt for future likely conditions because they are:

- **Purpose-built for uncertainty:** Scenarios give visibility to uncertainty, and you can use them to outline plausible future events and support your decision making;
- **Holistic:** Scenarios acknowledge that trends don't act in isolation;
- **Strategic:** Scenarios provide a more complete picture of future outcomes;
- **Creative:** Scenarios enable business to foresee different future contexts and formulate new strategic reasoning.

Rules Of Thumb for Decision Making

McKinsey Research Results

Making good business decisions is a critical part of every executive's job and is vital to every company's well-being. **Yet in a new McKinsey Global Survey on the topic, only 20 percent of respondents say their organisations excel at decision making.** Further, a majority say much of the time they devote to decision making is used ineffectively.

One of the survey's most noteworthy insights is how much time decision making really consumes. On average, just over half of respondent's report spending more than 30 percent of their working time on decision making and more than one-quarter spend a majority of their time making decisions.

Some of the key outcomes from the McKinsey & Co survey on decision making practices are shown in the diagrams below.

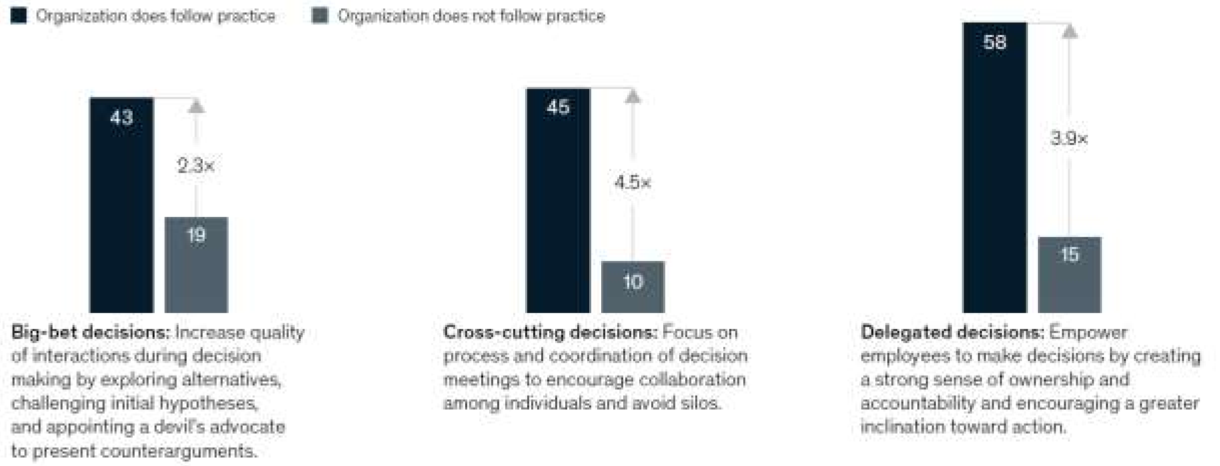
If you would like a copy of the full McKinsey article *"Decision Making in the Age of Urgency"* please click on the link HERE.

The results reveal three foundational practices that support good decision making across every decision type.

% likelihood of being a winner,[1] by organizations' adoption of foundational practices

Winning organizations tend to demonstrate best practices that are specific to each decision type.

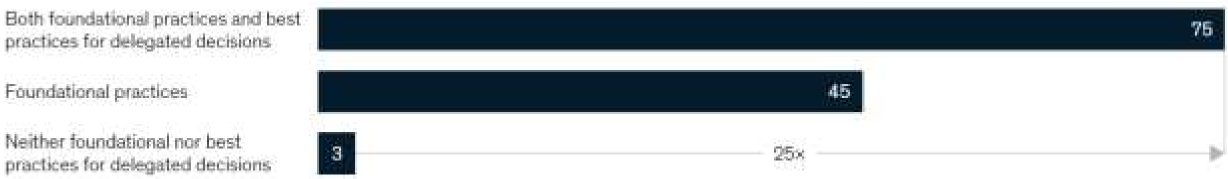
% likelihood of being a winner,[1] by organizations' adoption of decision-specific practices



[1] Respondents who said (a) that their organizations make high-quality decisions, (b) that their organizations make and execute decisions quickly, and (c) that their organizations see higher growth rates and/or overall returns from their decisions.

The likelihood of being a winner is higher when an organization follows both the foundational practices and those that are decision specific.

% likelihood of being a winner,[1] by organizations' adoption of practices for delegated decisions[2]



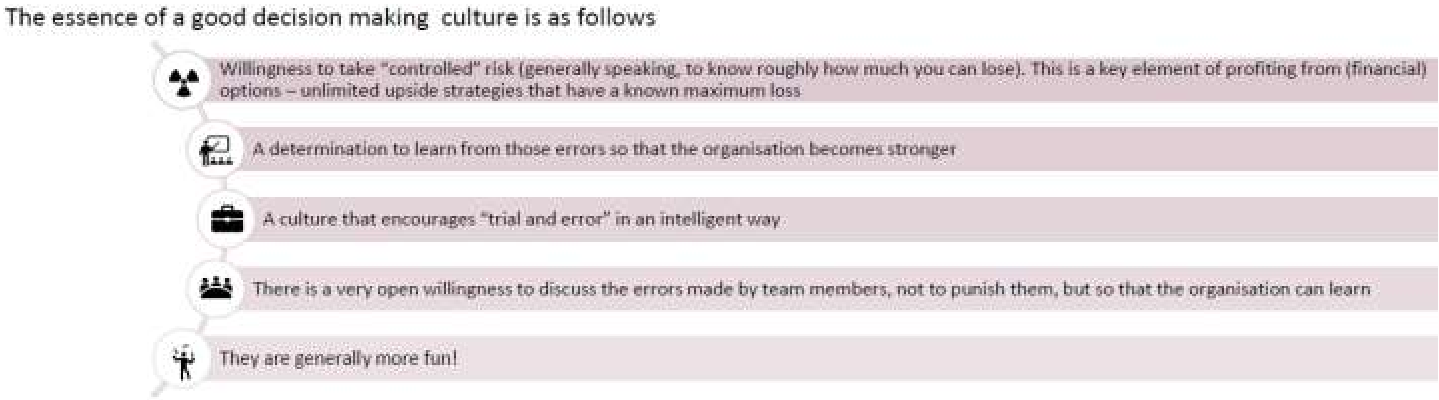
Conclusions

A decision is a commitment to a course of action to achieve a specific goal. Thinking about something is not the same as deciding. To decide you must commit to it and act on it.

To move forward, ask yourself the following questions:

- What are my goals here? What do I want to achieve?
- If there are several goals, what is the most important one?
- What action or set of actions do I need to do to achieve that goal?
- What do I need to commit to in order to take action?

What is the consequence of being at a critical crossroads? The most frequent negative impact is the natural temptation to stay where we are and pick neither path. The trouble with this is that we become inert, staring at the pathways ahead, but not moving forward along any of them. This can never be a good position to adopt for your business – take action using some of the approaches discussed in this article and be effectively decisive.

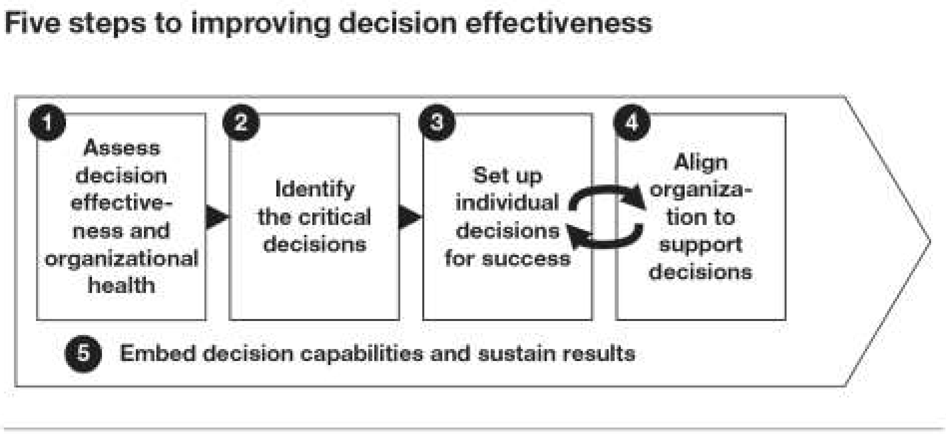


<u>**Source:**</u> ***"Risk Savvy: How to Make Good Decisions"*** Gigerenzer 2014 New York – Viking

Additional Resources

To obtain a copy of the excerpt from the HBR/Bain & Company book *"Decide and Deliver"*, which explains a plan for improving business decision effectiveness, by adopting and embracing the steps shown in the diagram below, please click on the link **[HERE]**.

To access a guide to improving your business decision making – *"Decide – The One Common Denominator of All Great Leaders"* please click on the link [HERE].



Improving your Business Drivers (Part 2)

This is the final part of the topic – Part 1 was in the October 2022 edition of the BusinessPlus newsletter.

Business Driver 3 – Net Operating Assets Management

Understanding the return on your net operating assets ("NOA's") used in the business operations is very important, with NOA defined as follows:

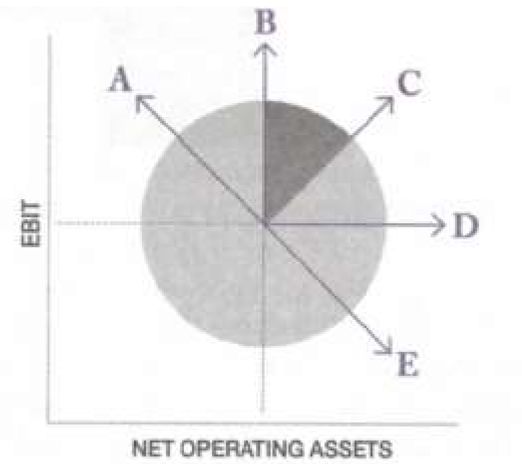
Net Operating Assets (NOA's) = Working Capital + Other Capital

Working Capital = Debtors & Stock/WIP less Creditors

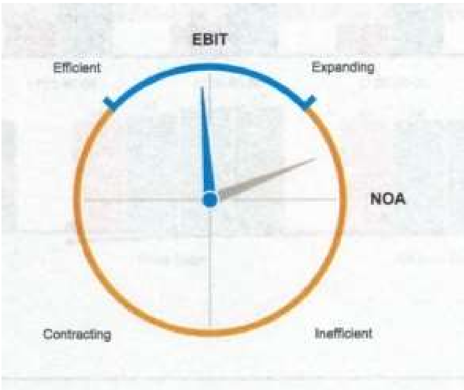
Other Capital = All Assets (excluding Working Capital and Cash) less all Liabilities (excluding Creditors and External Debt)

Your return on assets is ultimately a measure of the success of your strategy. If your return is not at appropriate levels, then management has five possible options:

- **Grow EBIT and net operating assets at the same rate (Expanding):** generally you can expect about the same return over time – see **line C** in the diagram below;
- **Increase EBIT and have static net operating assets (Efficient/Expanding):** you could expect an increase in in returns – see **line B** on the diagram;
- **Increase EBIT but reduce net operating assets (Efficient):** you could expect an increase in in returns – however this is likely not to be sustainable and generally short term in impact and not recommended other than as a short term measure – see **line A** on the diagram;
- **Leave EBIT the same but grow net operating assets:** this is shown by line D below and usually is a function of an investment in infrastructure resources strategy, to improve EBIT in the medium to longer term; or
- **Reduce EBIT and grow the net operating assets (Inefficient):** this is shown by line E below and usually is a function of a strategy to invest in business infrastructure, seeking to improve EBIT in the medium to longer term.



Generally, businesses need to adopt strategies that focus performance between lines A and C (efficient/expanding). This is where the EBIT is increasing faster than the underlying net operating assets employed in the business – thus growing returns on assets and meaning the business is expanding and being more efficient with its use of resources.



EBIT = **E**arnings **B**efore **I**nterest and **T**ax

The table below is based upon a sample company that is in a growth phase of its operations and is very profitable. It is illustrative only of what might be achieved by a high gross profit margin business (~ 48%) with EBIT of 24% and a net profit % of 15%.

Other Capital	30-06-2013 12 months	30-06-2014 12 months	Change
Other Capital %	29.19%	22.85%	-21.73%
Net Operating Assets %	41.31%	35.76%	-13.42%
Asset Turnover	2.42	2.80	15.50%
Return on Capital %	37.90%	66.99%	76.73%
Return on Total Assets %	26.18%	41.07%	56.86%
Return on Equity %	36.76%	56.41%	53.44%

The Return on Capital (net operating assets – NOA's) is extraordinarily strong in this illustrative example, based upon a fast growth business scenario.

More typically, a return of approximately 20% to 25% might be viewed as reasonable and attainable using a Net Operating Asset's basis and about a 12% to 15% return, for a total business assets basis of assessment.

Regardless of the specific benchmark target you set for Return on NOA's, it is a very important measurement of business performance.

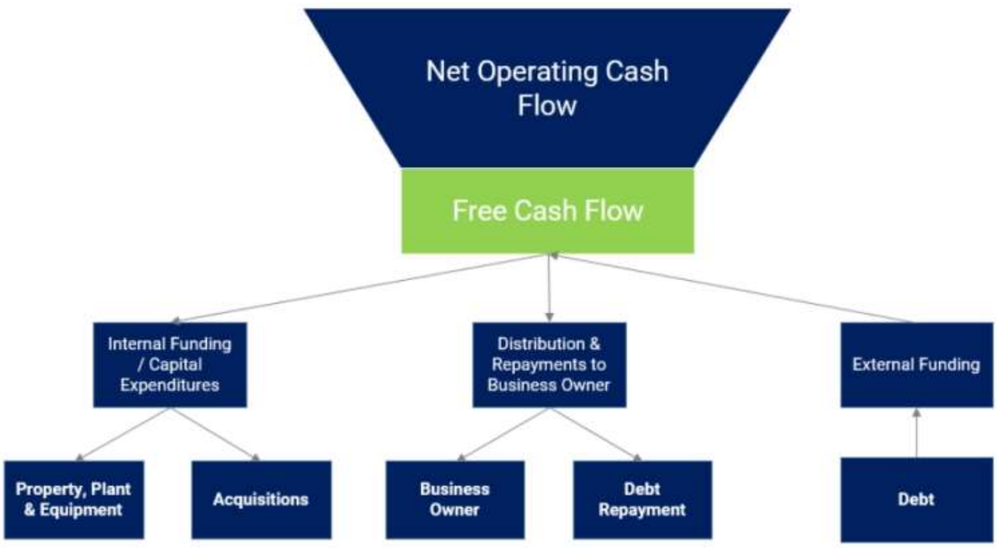
It is:

- The greatest single driver of return on equity (a determinant of business enterprise valuation);
- The prime measure of business operating efficiency;
- The ratio over which management has the most control in their decision making.

The two key factors determining Return on NOA's are:

- EBIT $'s ÷ Sales $'s expressed as a % = **the EBIT Margin %**; and
- Total Sales $'s ÷ Net Operating Assets $'s (as defined above) = the **Operating Assets Turnover of the business**.

Business Driver 4 – Cashflow/Funding



The three business drivers we have previously discussed – profitability, working capital management and management of net operating assets used in the business – are intrinsically linked to cashflow.

In addition, it is important for you to understand the differences between:

- Operating Cashflow;
- Marginal Cashflow;
- Free Cashflow; and
- Net Cashflow.

Operating Cashflow = [Net Profit before Tax + Non-Cash Depreciation/Amortisation] +/- Decrease or Increase in Working Capital requirements from the prior financial year

By applying this calculation, it will help you to understand the difference between net profit and cashflow from the business – and why they are never the same.

Marginal Cashflow % = Gross Profit Margin % - Working Capital %.

This is a measure of the internal growth capability for a business. For example, a negative % indicates a business cannot grow solely from internally generated sales, without additional funding from equity and/or debt and an improvement in sales margins and/or a lowering of the working capital % required, to turnaround the overall shortfall %; otherwise the business will be insolvent.

Free Cashflow = Operating Cashflow (as above) – [Capital Expenditure (internally funded) & Business Income Tax Paid]

Net Cashflow = Free Cashflow (as above) – [Any of the applicable items shown in the blue boxes, under the green Free Cashflow box in the diagram above].

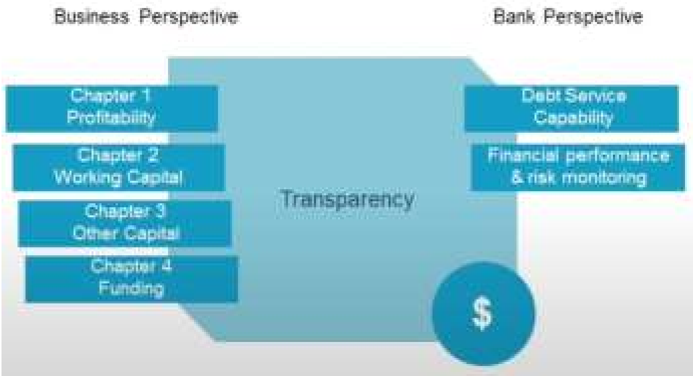
The last two cashflow numbers are of most interest to the business bankers, when reviewing the annual financial statements i.e., Free Cashflow and Net Cashflow.

You can review your forecast business trading position by applying the table below, to see the impacts on profit (EBIT) and cashflow for each of the relevant items shown and it is recommended you review the outcomes annually and make the appropriate changes to counter in adverse cashflow implications from the actual operating profit. **Remember only your available business cash (i.e., converted profits) and changes in debt positions, are the reality of the business operations from year to year.**

Your Power of One	Net Cash Flow $	EBIT $
Your Current Position		

Your Power of One	Change you would like to make	Annual Impact on Cash Flow $	Impact on EBIT $
Price Increase %	1 %		
Volume Increase %	1 %		
COGS Reduction %	1 %		
Overheads Reduction %	1 %		
Reduction in Debtors Days	1 day(s)		
Reduction in Stock Days	1 day(s)		
Increase in Creditors Days	1 day(s)		
Your Power of One Impact		0	0

The Bank's Perspective



From the business banker's perspective, they will always be focused upon the two items shown in the right hand side of the diagram above – debt servicing capabilities (both short and long term) and the consistency of the business's financial profitability & viability.

The banker's key perspectives can be summarised under two headings as follows:

a) <u>Risk Appetite:</u>

- Industry impacts on the business from the current economic climate or other "black swan" events;
- Adverse regional or international impacts on the business e.g., supply chain issues;
- Business security and resilience ratings.

b) <u>Debt Servicing Capacity:</u>

- Quality of business management;
- Business viability assessment;
- Business plans and quality of assumptions used;
- Cashflow stability of the business;
- Historical track record of performance against business plans and forecasts.

As part of this bank review process, they will apply the "4 C's" assessment to determine their rating for the particular business – as shown in the diagram below.

<u>Character:</u> The bank is looking to have confidence in the businesspeople they are dealing with - and integrity is the key. The bank's credit check assessments, supportive examples of past good account conduct and strong management skills of the business, all help provide the bank assurance in the business owner's ability. This collective assessment process helps the bank to determine their willingness to support the business in times of need for additional or new funding.

<u>Capacity:</u> The bank will assess a customer's capacity to service their funding needs using historical trading data, combined with future budget forecasts and measure these against the businesses projected debt service requirements. Generally, the bank will want to have for review three years prior financial year's accounts, together with cashflow & financial statement forecasts ("3 way projections") for the next 12 to 18 months (ideally including targeted, good and adverse scenario forecasts). This is to ensure the minimum level of debt service coverage is sustainable and achievable in the short to medium term – i.e., over the next 12 to 36 months.

Capital: The bank also wants to check that a business has enough equity and retained cash invested – i.e., has enough *"skin in the game"* to support the business. In essence the bank wants to know that the owners are taking a long-term view of their business and are not simply reliant on their bank to fully fund them.

Collateral: Banks tend to place less emphasis on collateral than capacity; however, they still want to know that the value of collateral provided in support of loans is sufficient. Collateral is seen as a secondary (although the least preferred) source of repayment, where circumstances adversely affect a business's long-term viability and cash flow is then insufficient to repay debt within the agreed terms and timeframes.

The main form of collateral the bank is interested in is unencumbered real estate. However, banks will consider other assets as collateral for certain forms of lending – for example, working capital finance secured by debtors and stock.

Collectively the bank's four C's assessment process aids them to formulate their risk assessment of a business – as shown in the diagram below. The stronger the assessment of the business by the bank, the lower the risk and the interest rate margin that is applied – reducing the loan funding costs to the business and perhaps the level of collateral required.

Cashflow stability is a crucial factor for banks. The diagram below shows the balancing act between cashflow stability and security provided to the bank by the business – ideally, they want to see that the business is assessed to be in the *"competitive"* or *"feasible"* quadrants on this diagram.

Conclusion

There are three things to consider when working with your bank – be it in good times or in times of uncertainty:

- **Timelines:** The bank always needs to be regularly updated on the business position and its requirements and particularly when adverse operating conditions or disasters are having an impact – urgency of required support communications with the bank is vital;
- **Honesty:** Be open and as candid as possible when presenting any actual or foreseen problems to the bank – that is the best way to getting their support; and
- **Have a Plan:** Wherever possible, present the business problem or proposal alongside a viable solution. Put together a comprehensive plan of how the business will satisfy the bank on the key issues it will want to be convinced about – lowering default risk, higher probability of success with the suggested solution presented, proven collateral security and a strong (proven) long term business strategy.

Collectively these sorts of considerations are summarised in the diagram below – the Bank's Risk Assessment Model:

Business Essential Briefs: Ransomware Protection Guides & Checklists

The Australian Cyber Security Centre (ACSC) recently produced a series of very useful guidance documents for SME businesses. This topic has come into focus once again with the high-profile hack of Optus in September 2022 and more recently Medibank Private and is a timely reminder to all business owners to spend time and resources protecting your business from this very real threat to operations.

Additional Resources

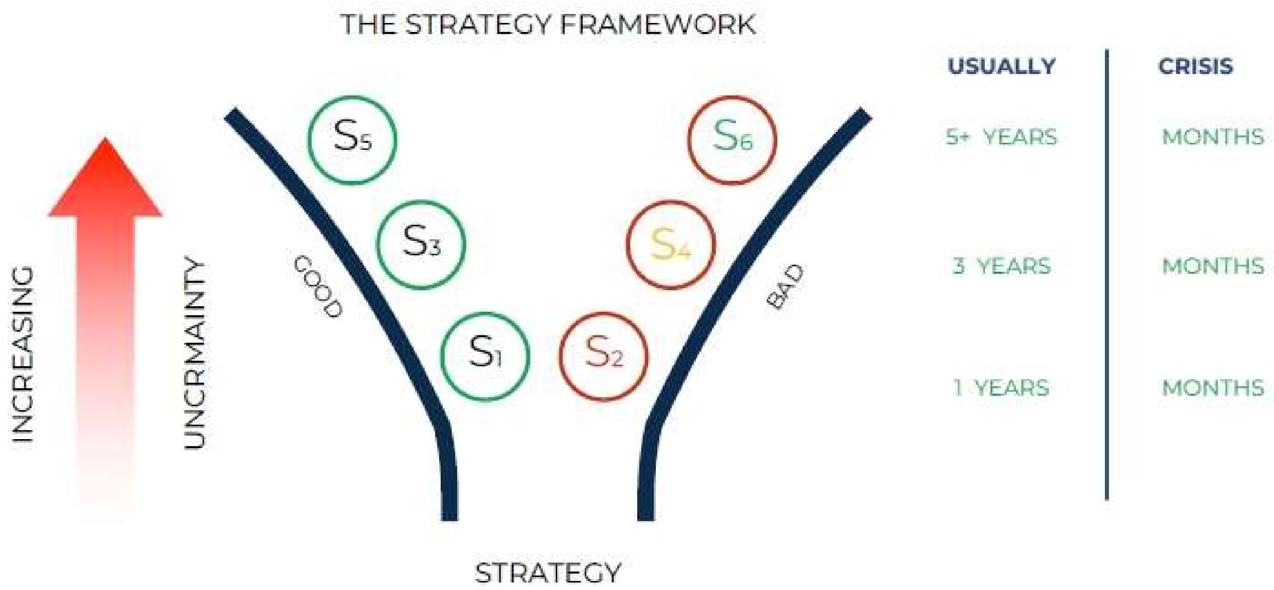
The following resources can be accessed for you to use:

Ransomware Prevention Guide – HERE;
Ransomware Emergency Response Guide – HERE;
Checklist - Respond to and recover from a Ransomware attack – HERE;
Ransomware Prevention Checklist – HERE.

Business Essential Briefs: Approaches to Business Operational Risk Management

Planning for your business in these uncertain times requires quick response from management using some appropriate approaches to adjusting your business operations. This is where different scenarios can be explored to determine the potential impacts on your business. Having a useful model to assist you in developing and reviewing your scenario options can be of great assistance – in this case called The Strategy Funnel, which was developed by Bryan Whitefield – an Australian Risk Management Business Consultant.

His model is shown in the diagram below and certainly may assist you in developing better strategic direction for your business.



***Source:* Bryan Whitefield – The Strategy Funnel**

Additional Resource

***To access a copy of the article by Bryan Whitefield on The Strategy Funnel*, please click on the link HERE.**

A recent PWC Global Risk Survey 2022 report provides some useful guidance on how SME's might improve their strategic risk management capabilities and suggests five key actions that organisations should adopt to confidently navigate this uncertainty and capitalise on opportunities, whilst mitigating against any downside "black swan" events.

The benefits of adopting the appropriate actions may result in a several good outcomes for SME's, including:

Business Outcomes:
- Increased business value with an improved business model
- More effective leadership
- Improved returns on strategic investments

Growth-Minded Risk Culture:
- Improvement in organisational resilience and agility
- Development of a stronger risk awareness culture
- Making business decisions faster and more effectively

In addition, the ***PWC 2022 Global Risk Survey*** provides some very useful insights into the current top risks for Australian business revenue growth, as shown in the diagram below.

Additional Resource

The full *PWC Global Risk Survey 2022* report can be accessed by clicking on the link HERE.

Providing you professional direction