

BusinessPlus+ Newsletter

Issue – December 2023

Practical Financial Lessons for Business Owners

Financial statements and management accounts are fundamental tools for business owners and managers to make informed decisions, evaluate performance, allocate budgets, and navigate the complexities of business management. Yet many business owners and managers have only a superficial understanding of finances and make decisions based on a limited understanding or limited information.

There are several common issues that business owners and managers need to be mindful of, when looking at their business fundamentals, as outlined below.

Strategy

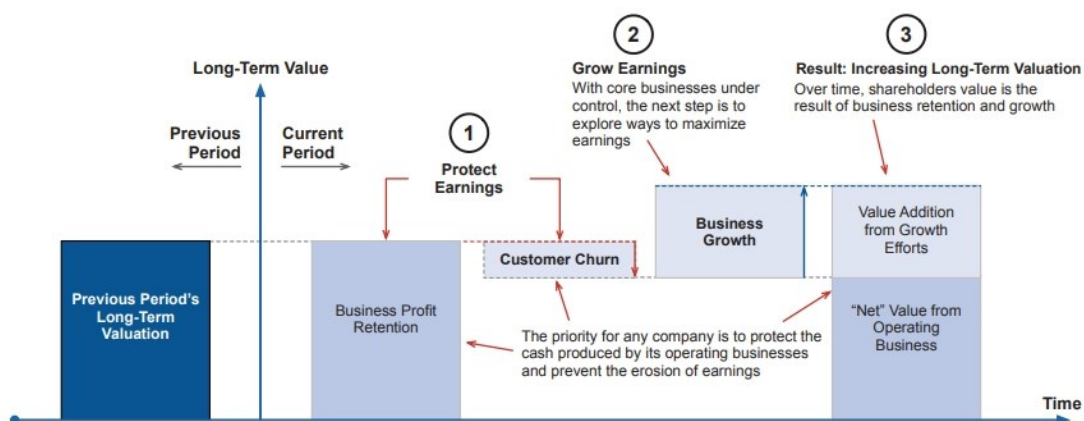
Critical Questions Your Strategy Should Answer

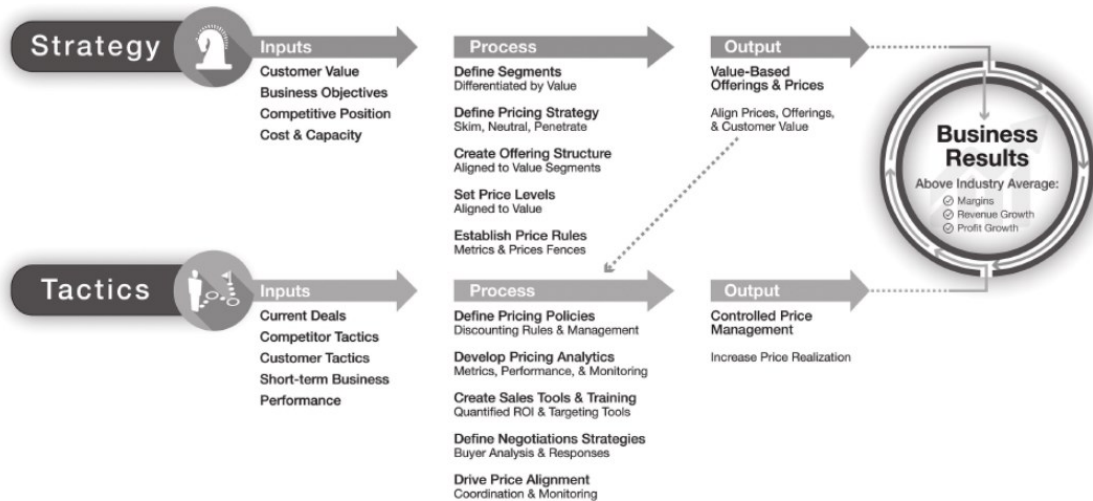
-  **What business or businesses should your company be in?**
-  **How should you add value to your businesses?**
-  **Who should be the target customers for your businesses?**
-  **What should be your value propositions to those target customers?**
-  **What capabilities should differentiate your ability to add value to your businesses and deliver their value propositions?**

Building Business Value

Most owners and managers have a good understanding of profit and loss, however, are less clear about whether they are building business value. What is the relationship between the profit and loss and the balance sheet and where is the value of the business reflected in the financial statements?

Understanding how to build ongoing business value will positively impact your business.





Cash is King



Most people have heard the statement, “Cash is King”, but many owners don’t operate their business to align with this statement. **The key is for business owners and managers to understand the relationship between profit and loss, cash, and business value.** Understanding the levels of cash tied up in the business, cash required for growth, and how much free cash flow the business is generating is really important.

What Type Of Business are you running?

The Three Freedoms



Are you achieving the freedoms you should be striving for in operating your business, as detailed in the diagram above?

Is business success based more on fixed cost improvement or variable cost control? Owners and managers often do not fully **understand the key drivers of profitability** or are focusing on costs in the wrong area for limited return or in some cases creating a detrimental effect. Being clear on your business model is an important first step in the process.

Indirect vs Direct Costs

Often internally generated financial reports have the incorrect allocation of expenses or revenue. Expenses that should be included in direct costs are allocated to indirect costs **meaning the gross profit margin (a key business indicator & benchmark)** is inaccurate. Similarly, revenue or expenses aren't allocated to the correct time period (month or year), which may be perceived to aid taxation, but distorts the ongoing correct profitability story. Fixing these items is generally a straightforward process that provides significant rewards year-in-year-out.

Matching Expenses and Overheads to Income

$$R - E = P$$

R = Revenues (or sales)

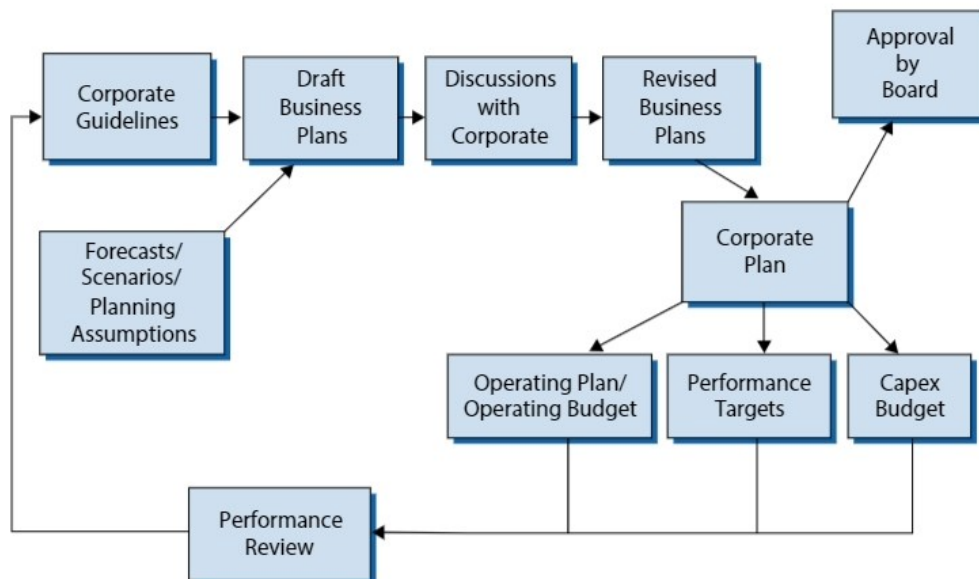
E = Expenditures (or costs)

P = Profit (or the bottom line)

By including an additional dollar of sales to the business, the top line increases (gross sales), but unless expenditures are less than the amount of the sale, the contribution to the profit line will be zero or less (i.e., a negative or loss). However, by reducing expenditures by a dollar (all other things being equal), the reduction will fall directly to the bottom line and increase profits on a dollar-by-dollar basis. Accordingly, small business success is dependent on the small business owner acquiring only quality sales from quality customers (i.e., those sales that contribute a desired profit to the bottom line) and maintaining costs at a minimum. Of course, the small business owner must be aware of the costs and related pricing structure for each of the company's products and services and customers.

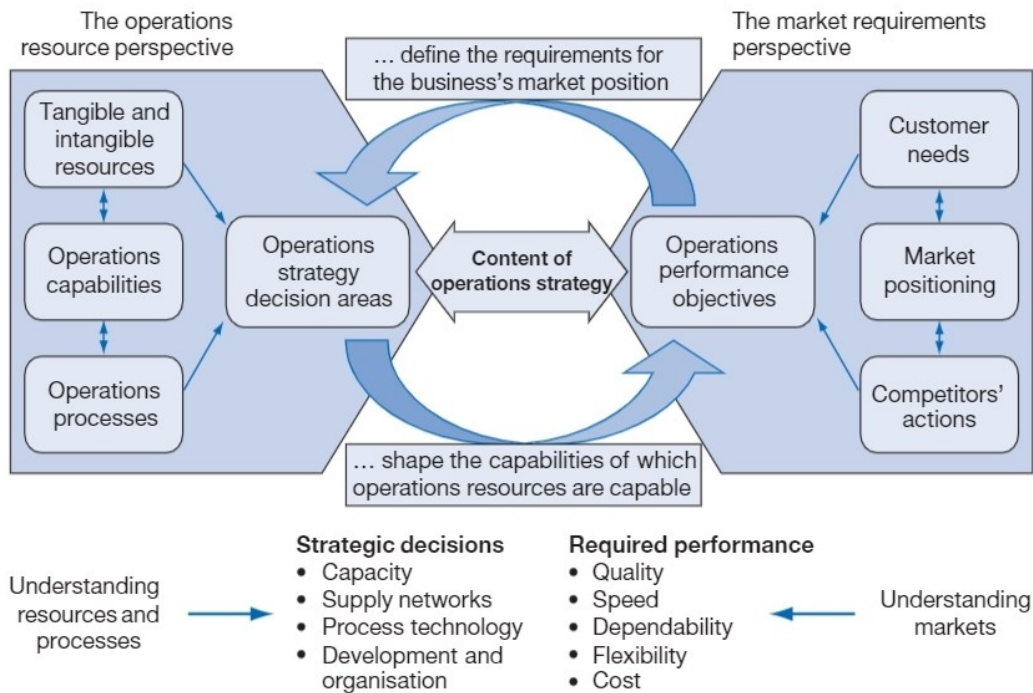
This is particularly important in job or project-based businesses where a key driver of success is job costing. Sadly, some standard small business accounting platforms are limited in their job-costing capability without add-ons. Whether it is by using spreadsheets or additional job costing tools, it is essential for business owners and managers to understand the profitability of individual projects or product and service lines. There are many good accounting package options available to make job/project costing easy to implement and track.

No Budgets or Forecasts



Many businesses operate without any kind of budget or forecast, effectively flying blind and having no measure of success. **Budgeting is a reasonably simple process for established businesses.** Historical numbers provide a level of understanding and a base for future budgets or forecasts. The key is taking time to define a budget and forecast and then review it on a regular basis (at least monthly).

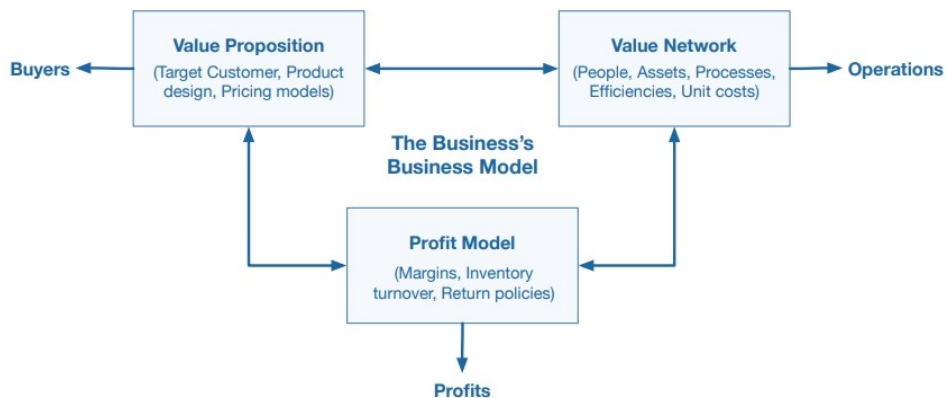
Competing Internal Priorities



Sometimes in a business, there is limited recognition of how decisions that benefit one area are detrimental to other areas. It's the classic Sales fighting with Production or Accounts due to competing priorities or terms of trade. Giving away discounts, offering late payment terms or over-promising delivery timeframes, all of which affect the profitability and cash in the business moving forward. **Alignment between business divisions and objectives needs to be addressed, so that the company can succeed as one.**

Aligning Leadership with an Agreed Operating Model

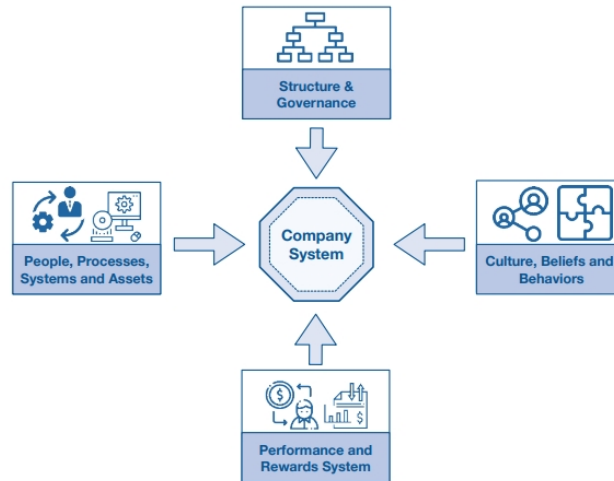
It isn't uncommon to find that the apparent accord around a strategy is but a thin veneer, and below the surface there is a morass of conflicting assumptions. **Yet there are real ways to deal with this issue, not least of which is the development of an agreed business model and getting the leaders aligned on an operating model.**



While the business model stage is essential, it is not sufficient. **Leaders can only truly be aligned when they have a common and agreed concept of the operating model.** If the business model gives you the bricks to the house, then the operating model gives you the plumbing and electrical works. Without the operating model you can have an elegant looking but non-functional home.

The operating model determines how you build real-value streams that practically deliver customer value. This means understanding:

- Which functions are necessary.
- Which parts of a value stream do they deliver.
- Where the functions are located.
- How they are organised into structures.
- Which policy principles they should adhere to.
- What roles exist within those functions.
- Which processes go across functions.
- What technologies make it all work optimally.



The Business Operating Model's Key Components

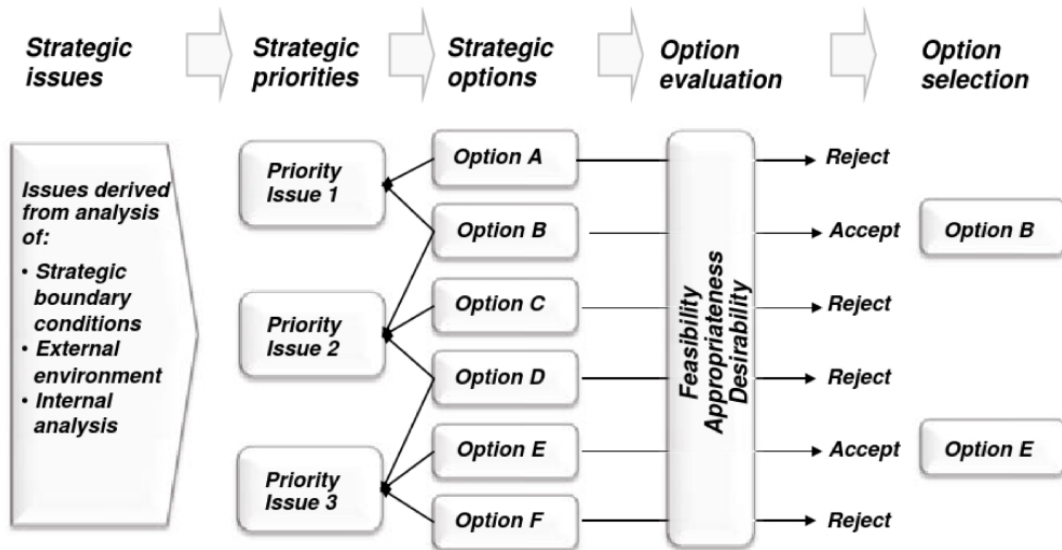
It is the operating model that staff really see and work with, for it defines the jobs they do, where they work, the technologies they use, and even to whom they report. The operating model takes strategy out of the cloud and brings it to life.

The best way to get alignment is to be in a room together nutting it out with a skilled facilitator: start with strategy, move to the business model and finish on the operating model.

An agreed operating model can be the difference between an aligned leadership team and a fumbled execution of strategy. Having a hypothetical operating model prepared in advance, which can be rejected or changed, can speed up the process. Leaders are busy, but they should never be too busy to work out where they are going.



Execution of Strategy



The real execution of a strategy must address the strategy itself, which outlines where to compete and how to win; and the business model, which addresses the basic building blocks of how the strategy is delivered. Osterwalder and Pigneur (2010) describe the business model as a blueprint for strategy, which means, at a minimum, describing your intentions around:

Which Customer Segments You Will Target:

- What value propositions will attract those customers.
- Through which channels you will make your offer and service those customers.
- How the customer relationships will be maintained (e.g., through great products, great service, low cost).
- What resources are required to deliver on your promises.
- What activities will these resources, at a very high level, perform; and
- Which outsourced business partnerships are needed to ensure you can successfully deliver a great customer experience.

It might sound like common sense so far, yet frequently leaders don't have a consistent view of these critical elements. Furthermore, most of the time the business model is still very conceptual, and it is hard to execute on all the elements.

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