Achieving Financial Success

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About the Guide

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Introduction

Small business is often driven by a passion for achieving the owners' desired outcomes. They may want to watch a business grow from the start, be keen to enter into an industry that provides great challenge, or be motivated by personal reasons such as wanting to turn a hobby into a business or develop a long-term retirement plan. Whatever their reason, many small business owners do not have formal financial management training (that is they are not an accountant or bookkeeper) and usually are limited in resources to fund this type of assistance.

For the success of any business, good financial management is necessary. Good financial management will go a long way in helping you ensure all your available business resources are used efficiently and effectively and provide an optimum return to you.

This guide has been designed to help those in small business develop the financial management skills that are an essential part of business success.

Presented in easy-to-understand language, this guide discusses the key financial aspects small business should focus on to ensure good financial management is in place. The areas discussed in the guide address the financial aspects your business should consider and understand as part of good financial management.

If these practices are implemented early, your business will benefit from strong financial management and you will be equipped with the financial tools to operate and grow a successful business.

Of course, for each business, some of the areas may not be relevant. For instance, if you are providing a service, then discussion of stock management will not be relevant. Also, you will need to keep in mind the type of industry you operate in when considering good financial management. For example, if you run a café, you will probably be reviewing stock levels every week; however, a small retail toy shop may only do a stock count once a year.

This guide has five sections, each with a number of chapters that provide discussion on the key topics. There are hints and tips along the way to help you focus on the important messages and these are summarised in Appendix 1 for easy reference.

Section One	Business Finance Basics
Section Two	Improving Business Finance
Section Three	Financing Your Business
Section Four	Managing Lenders
Section Five	Better Business Financial Management

The guide is designed to provide an overview, and, in most topics covered, there are references to further information that can be found on Small Business Victoria or CPA Australia's websites.

Glossary of Terms Used in This Guide

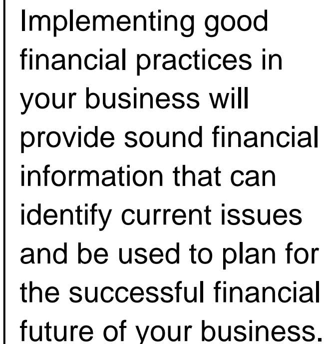
As with any topic, there is a wealth of jargon and terminology associated with financial management. It is helpful for you to understand these terms when reading financial statements or when talking to finance professionals such as bank managers. This will make you feel more confident and comfortable. The most basic and useful of these terms are set out below.

Term	Definition
Accrual Accounting	Recognising income and expenses when they occur rather than when they are received or paid for
Accounting Entry	The basic recording of business transactions as debits and credits
Accounting Period	A period for which financial statements are prepared – normally monthly and then annually
Asset	Anything having a commercial value that is owned by the business
Break Even	The amount, in either units or dollar value, that the business needs to achieve before a profit is generated
Budget	A financial plan for a business (setting out money the business forecasts it will receive and spend); typically done once a year
Capital Expenditure	The amount of money that is allocated or spent on assets
Cash Accounting	Accounting for transactions as they are received or paid
Cash Conversion Rate	The overall number of days to convert your trade from the cash outflow at the beginning of the working capital cycle to cash received at the end of the cycle
Cashflow	The flow of cash into and out of the business
Cost of Goods Sold (COGS)	The total cost of all goods sold during the period
Creditors	The money which you owe your suppliers
Current Assets	Are assets that are likely to be turned into cash within a twelve month period
Current Liabilities	Are liabilities that are required to be paid within a twelve month period
Debtors	The money which is owed by your customers to you
Depreciation	The write-off of a portion of a fixed asset's value in a financial period

Drawings	Where the owner/s of the business take something of monetary value permanently out of the business – can be cash or other assets
Equity	The amount that the business owes the owners
Expenses	The costs associated with earning the business income
Financial Ratio	The method by which business can measure the financial health and compare their business operations to similar businesses in the same industry
Financial Statements	Financial Statements (Profit and Loss Statement, Balance Sheet and Statement of Cash Flows) record the financial performance and health of your business for a given period
Forecasting	The process of predicting the future financial performance of a business
Inventory	The stock that a business holds to sell
Intangibles	Assets that don't have a physical form e.g. patents, goodwill
Liability	The amount the business owes external stakeholders
Margin	Profit from sales before deducting overheads
Mark-up	The percentage by which the sales price exceeds the cost
Owners' Equity	The amount of capital contributed to form the business or added later
Overheads	Costs not directly associated with the products or services sold by the business
Profit	Revenue minus expenses
Purchase Order	A commercial document issued by a buyer to a seller, indicating the type, quantities and agreed prices for products or services the seller will provide to the buyer
Receivables	Amounts that are owed to a business; also known as debtors
Revenue	The income the business earns from its operations
Retained Profit	Profits that have not been distributed to the owners
Reserves	Retained profits that are held for a specific purpose or the result of a revaluation of assets
Working Capital	The excess of current assets over current liabilities
Work in Progress	Where an order has been taken from the customer and the business is in the process of "working" to complete the order.

Business Finance Basics

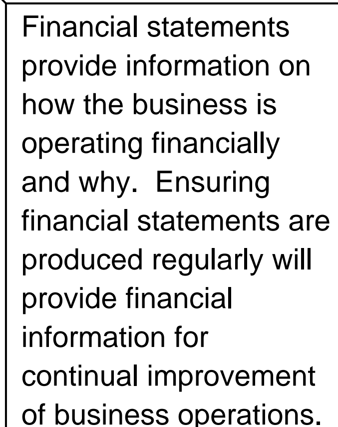
Keeping the books for your business can provide valuable information to enable you not only to prepare the Business Activity Statements (BAS), but also to gain a clear picture of the financial position of your business and an insight into how to improve business operations. Good financial systems will assist in monitoring the financial situation, managing the financial position and measuring the success of your business.



In this first section, we will look at the three key financial statements and then discuss how you can use this information to improve business operations through ratio analysis and preparing an operating budget.

Chapter 1: Understanding Financial Statements

Please note this chapter is not designed to assist you with the preparation of financial statements but to introduce you to what they look like and how they can be used to benefit your business.



Every business requires some assets to be able to run the operations and ultimately make a profit. This could be as simple as having cash in the bank, but is more likely to be a number of assets, such as stock (only unsold stock is an asset), office equipment and perhaps even commercial premises. All of these items need to be paid for, so, when starting up a small business, the owner or owners will need to invest some of their own money as well as perhaps borrowing some from a lender (e.g. bank) or investor.

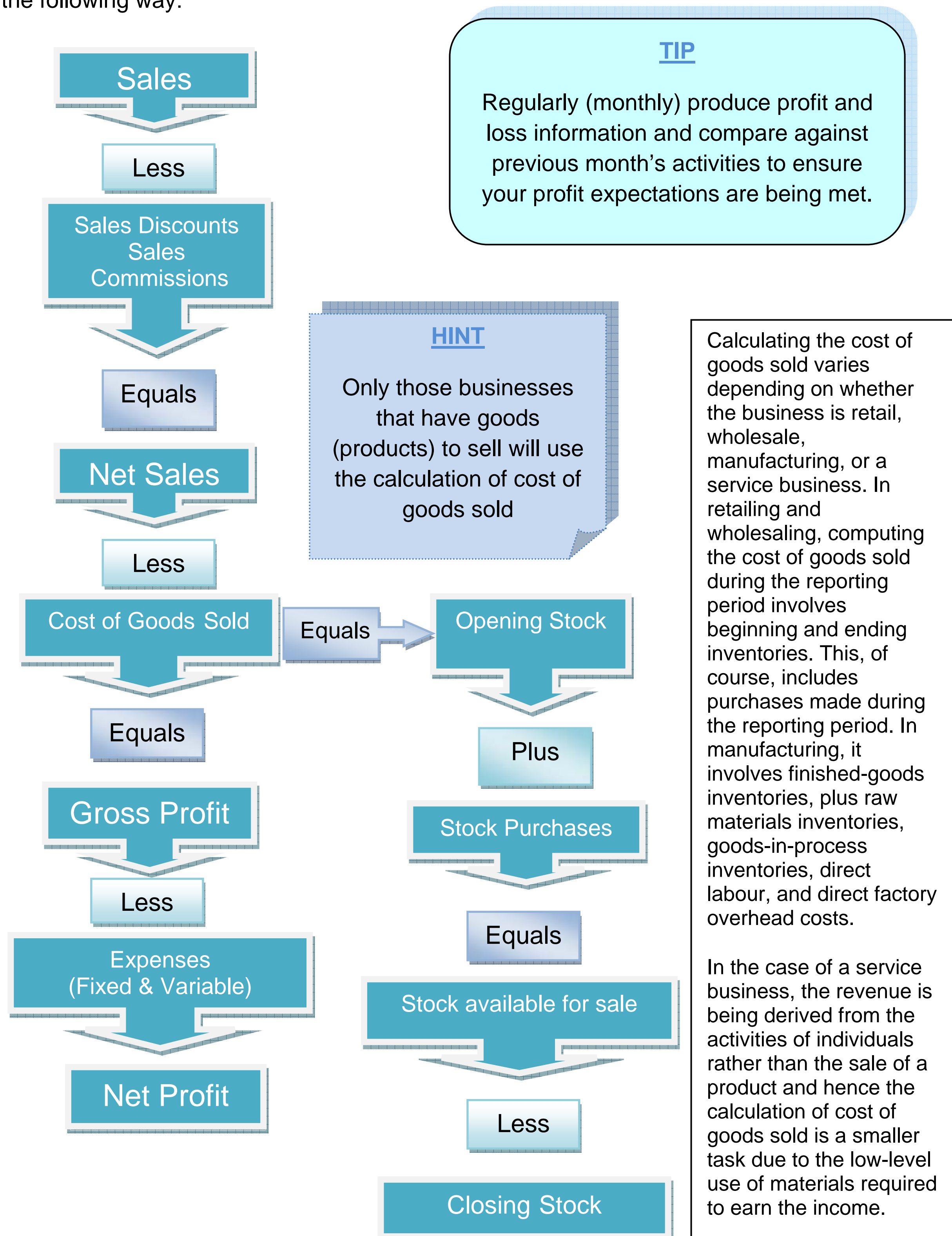
There are three financial statements that record financial information on your business. They are:

- **Profit and loss statement** (sometimes referred to as statement of financial performance or income statement)
- **Balance sheet** (sometimes referred to as the statement of financial position)
- **Statement of cashflows.**

Financial statements record the performance of your business and allow you and others to diagnose the strengths and weaknesses by providing a written summary of the financial activities for a given period. To proactively manage your business, you should plan to generate these financial statements on a monthly basis, review the results and analyse for improvements. Let's look at the financial statements and see how they can assist in monitoring your businesses financial performance.

Profit and loss statement

The profit and loss statement is a summary of a business's income and expenses over a specific period. It should be prepared at regular intervals (usually monthly and at financial year end) to show the results of operations for a given period. Profit or loss is calculated in the following way:



Case Study – Joe's Motorbike Tyres

Joe has decided to start up his own business and has been doing some research. He will sell motorbike tyres to motorbike manufacturers. He is going to leave his employment and has saved some money to help him through the start phase. He has decided that in the first year, he is going to focus on getting the business established, so he believes that a small profit (before interest and tax) of $ 5,000 should be achievable. His research has shown him that the expenses to set up and operate the business will be approximately $15,600 for the year.

Profit	$5,000	plus operating expenses	$15,600
Total cash needs	$20,600		

From this information, Joe can see that he will need at least $20,600 to cover the operating expenses and achieve his profit goal. This is called the gross profit. Joe's research has also highlighted that it is reasonable to expect to sell at least 1000 tyres in the first year. Joe has negotiated with a supplier to provide the tyres for cost price of $31.20 each. Now we can work out according to Joe's estimates, what sales need to be made to reach the profit goal.

Profit	$5,000	plus operating expenses	$15,600
Plus cost of 1000 tyres	$31,200	(cost of goods sold)	
Joe will need a total of	$51,800	to achieve his targeted profit	

Minimum selling price ($51,800 divided by the 1000 tyres he will sell) equals $51.80 per tyre.

Joe thinks he will be able to sell the tyres for $52.00 per tyre, so, at the end of the first year, if all goes according to plan, his profit and loss statement would look like this:

Joe's Motorbike Tyres
Profit and Loss Statement As at end of Year One

Income			
	Sales	$52,000	(1,000 tyres @ $52 each)
	Total sales	$52,000	
Cost of goods sold			
	Opening stock	$ -	
	Stock purchases	$34,320	
	Less closing stock	$3,120	
Total cost of goods sold (COGS)		$31,200	(See note below)
Gross profit		$20,800	
Expenses			
	Advertising	$500	
	Bank service charges	$120	
	Insurance	$500	
	Payroll	$13,000	
	Professional fees (legal, accounting)	$200	
	Utilities & telephone	$800	
	Other: computer software	$480	
	Expenses total	$15,600	
Net profit before tax		$5,200	

Note: Towards the end of the year, Joe purchases 100 more tyres on credit from his supplier for an order in the new year. This leaves $3,120 of stock on hand at the end of the year.

Joe's cost of goods calculation

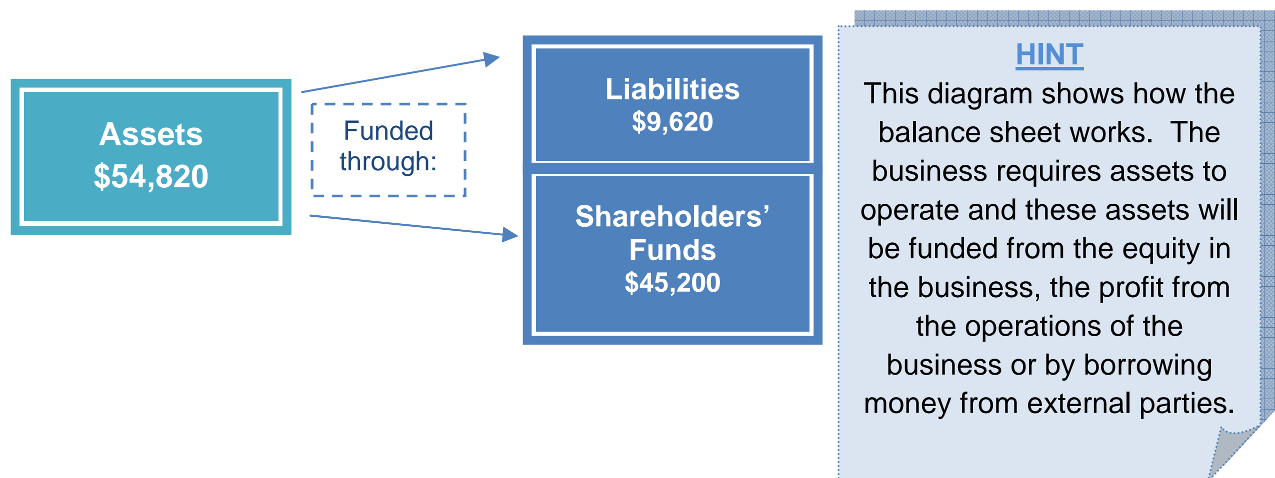
Opening stock	Nil	
Add stock purchased during the year	$34,320	(1100 tyres @ 31.20 each)
Equals stock available to sell	$34,320	
Less stock on hand at end of year	$3,120	(100 tyres @ 31.20 each)
Cost of goods sold	$31,200	

If your business is a **service business**, (i.e. selling services not goods or products), the profit and loss statement will generally not have a cost of goods sold calculation. In some instances, where labour costs can be directly attributed to sales, then you may consider including these costs as a cost of goods (services) sold.

Balance sheet

The balance sheet provides a picture of the financial health of a business at a given moment in time (usually the end of a month or financial year). It lists in detail the various assets the business owns, the liabilities owed by the business, and the value of the shareholders' equity (or net worth of the business).

- Assets are the items of value owned by the business
- Liabilities are the amounts owed to external stakeholders of the business
- Shareholders equity is the amount the business owes the owners.



The balance sheet can also be illustrated as:

The diagram above shows that the value of all of the assets of the business less the value owed to external stakeholders (liabilities) will equal the net worth of the business – that is, the value of the business after all debts have been paid.

Balance Sheet Categories

- **Assets** can include cash, stock, land, buildings, equipment, machinery, furniture, patents, and trademarks, as well as money due from individuals or other businesses (known as debtors or accounts receivable).
- **Liabilities** can include funds made available to the business from external stakeholders by way of loans, overdrafts and other credit used to fund the activities of the business including the purchase of capital assets and stock, and for the payment of general business expenses.
- **Shareholders' equity** (or net worth or capital) is money put into a business by its owners for use by the business in acquiring assets and paying for the (sometimes ongoing) cash requirements of the business.

Balance Sheet Classifications

For assets and liabilities, a further classification is made to assist in monitoring the financial position of your business.

These classifications are referred to as “current’ and “non-current”. Current refers to a period of less than twelve months and non-current is any period greater than twelve months.

Current assets will include items that are likely to be turned into cash within a twelve-month period – cash in the bank, monies owed from customers (referred to as debtors), stock and any other asset that will turn into cash within twelve months. Fixed assets are shown next on the balance sheet and are assets that will continue to exist in their current form for more than twelve months. These can include furniture and fittings, office equipment, company vehicles etc.

In the same way, liabilities are listed in order of how soon they must be repaid with current liabilities (less than 12 months) coming first, then non-current liabilities (longer than 12 months), followed by shareholders’ funds (equity). Current liabilities are all those monies that must be repaid within twelve months and would typically include bank overdrafts, credit card debt and monies owed to suppliers. Non-current liabilities are all the loans from external stakeholders that do not have to be repaid within the next twelve months.

TIP

A prosperous business will have assets of the business funded by profits rather than being heavily reliant on funding from either external parties (liabilities) or continual cash injections from the owner (equity).

Following on from the case study of Joe's Motorbike Tyres, this is what Joe's balance sheet would look like at the end of year one:

Joe's Motorbike Tyres
Balance Sheet
As at end of Year One

Current Assets			
Cash	$5,100		
Debtors	$18,000		
Stock	$3,120		
Total Current Assets		$26,220	
Non-current Assets			
Computer	$5,500		
Store Fit Out	$8,100		
Office Equipment	$15,000		
Total Non-current Assets		$28,600	
TOTAL ASSETS		**$54,820**	
Current Liabilities			
Credit Card	$5,500		
Creditors	$4,120		
Total Current Liabilities		$9,620	
Non-current Liabilities			
Total Non-current Liabilities			
TOTAL LIABILITIES		**$9,620**	
NET ASSETS			**$45,200**
Shareholders' Equity			
Owners' Funds		$40,000	
Current Year Profit		$5,200	
TOTAL SHAREHOLDERS' EQUITY			**$45,200**

Statement of cashflows

The statement of cashflows is a summary of money coming into, and going out of, the business over a specific period. It is also prepared at regular intervals (usually monthly and at financial year end) to show the sources and uses of cash for a given period.

HINT

Statement of cashflows only shows the historical data and differs from a cashflow forecast

The cashflows (in and out) are summarised on the statement into three categories: operating activities, investing activities and financing activities.

Operating activities: These are the day-to-day activities that arise from the selling of goods and services and usually include:

- Receipts from income
- Payment for expenses and employees
- Payments received from customers (debtors)
- Payments made to suppliers (creditors)
- Stock movements.

Investing activities: These are the investments in items that will support or promote the future activities of the business. They are the purchase and sale of fixed assets, investments or other assets and can include such items as:

- Payment for purchase of plant, equipment and property
- Proceeds from the sale of the above
- Payment for new investments, such as shares or term deposits
- Proceeds from the sale of investments.

Financing activities: These are the methods by which a business finances its operations through borrowings from external stakeholders and equity injections, the repayment of debt or equity, and the payment of dividends. Following are examples of the types of cashflow included in financing activities:

- Proceeds from the additional injection of funds into the business from the owners
- Money received from borrowings
- Repayment of borrowings
- Payment of drawings (payments taken by the owners).

As already mentioned, the statement of cashflows can be a useful tool to measure the financial health of a business and can provide helpful warning signals. Three potential warning signs which, in combination, can indicate the potential for a business to fail are:

- Cash receipts are less than cash payments (i.e. you are running out of money)
- Net operating cashflow is an "outflow" i.e. it is negative
- Net operating cashflow is less than profit after tax (i.e. you are spending more than you earn).

TIP

Use the cashflow statement to analyse if you are spending more than you are earning or drawing out too much cash from the business.

Here is an example of Joe's cashflow statement, showing the relationship between the profit and loss statement and the balance sheet.

Joe's Motorbike Tyres
Balance Sheet
As at end of Year One

Current Assets			
Cash	$5,100		
Debtors	$18,000		
Stock	$3,120		
Total Current Assets		$ 26,220	
Non-Current Assets			
Computer	$5,500		
Store Fit Out	$8,100		
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Total Non-Current Assets		$ 28,600	
TOTAL ASSETS		$ 54,820	
Current Liabilities			
Credit Card	$5,500		
Creditors	$4,120		
Total Current Liabilities		$ 9,620	
Non-Current Liabilities			
Total Non-Current Liabilities			
TOTAL LIABILITIES		$ 9,620	
NET ASSETS			$ 45,200
Shareholder's Equity			
Owners Funds		$ 40,000	
Current Year Profit		$ 5,200	
TOTAL SHAREHOLDERS EQUITY			$ 45,200

Joe's Motorbike Tyres
Statement of Cash Flows
For the period ending Year One

Cash flows from operating activities		
Receipts from Income	$52,000	
Payments of expenses	-$15,600	
Funding to Debtors	-$18,000	
Stock Movement	-$34,320	
Funding from Creditors	$4,120	
Net cash from operating activities		-$11,800
Cash flows from investing activities		
Payments for property, plant and equipment	-$28,600	
Net cash from investing activities		-$28,600
Cash flows from financing activities		
Increase in short term Debt	$5,500	
Increase in Long Term Debt		
Proceeds from owners (equity)	$40,000	
Net cash from financing activities		$45,500
Net increase in cash		$5,100
Cash balance as at start of year		
Cash balance as at end of year		$5,100

Joe's Motorbike Tyres
Profit and Loss Statement
For the period ending Year One

Income	
Sales	$52,000
Total Sales	$52,000
Cost of Goods Sold	
Opening Stock	$0
Stock Purchases	$34,320
Less Closing Stock	$3,120
Total Cost of Goods Sold (COGS)	$31,200
Gross Profit	$20,800
Expenses Total	$15,600
Net Profit before Tax	$5,200

Chapter 2: Assessing Your Business's Financial Health

A helpful tool that can be used to predict the success, potential failure and progress of your business is financial ratio analysis. By spending time doing financial ratio analysis, you will be able to spot trends in your business and compare the financial performance and condition with the average performance of similar businesses in the same industry. Small Business Victoria has access to industry information provided by IBISWorld. CPA Australia also has similar industry information provided by benchmarking company FRMC which can be accessed through CPA Australia's library.

Although there are many financial ratios you can use to assess the health of the business, in this chapter we will focus on the main ones you can use easily. The ratios are grouped together under the key areas you should focus on.

Financial ratio analysis will provide the all-important warning signs that could allow you to solve your business problems before they destroy your business.

Liquidity ratios

These ratios will assess your business's ability to pay its bills as they fall due. They indicate the ease of turning assets into cash. They include the current ratio, quick ratio, and working capital (which is discussed in detail in Chapter 5).

In general, it is better to have higher ratios in this category, that is, more current assets than current liabilities as an indication of sound business activities and an ability to withstand tight cashflow periods.

HINT

Use these ratios to assess if your business has adequate cash to pay debts as they fall due.

Current ratio = $\dfrac{\textbf{Total current assets}}{\textbf{Total current liabilities}}$

One of the most common measures of financial strength, this ratio measures whether the business has enough current assets to meet its due debts with a margin of safety. A generally acceptable current ratio is 2 to 1; however, this will depend on the nature of the industry and the form of its current assets and liabilities. For example, the business may have current assets made up predominantly of cash and would therefore survive with a relatively lower ratio.

Quick ratio = $\dfrac{\textbf{Current assets – inventory}}{\textbf{Current liabilities – overdraft}}$

Sometimes called the "acid test ratio", this is one of the best measures of liquidity. By excluding inventories which could take some time to turn into cash unless the price is "knocked down," it concentrates on real, liquid assets. It helps answer the question: If the business does not receive income for a period, can it meet its current obligations with the readily convertible "quick" funds on hand?

TIP

The quick ratio will give you a good indication of the "readily" available cash to meet current debt obligations.

Solvency ratios

These ratios indicate the extent to which the business is able to meet all its debt obligations from sources other than cashflow. In essence, it answers the question: If the business suffers from reduced cashflow, will it be able to continue to meet the debt and interest expense obligations from other sources? Commonly used solvency ratios are:

HINT

These ratios measure if your business has adequate long-term cash resources to cover all debt obligations.

Leverage ratio = $\dfrac{\textbf{Total liabilities}}{\textbf{Equity}}$

The leverage (or gearing) ratio indicates the extent to which the business is reliant on debt financing versus equity to fund the assets of the business. Generally speaking, the higher the ratio, the more difficult it will be to obtain further borrowings.

Debt to assets = $\dfrac{\textbf{Total liabilities}}{\textbf{Total assets}}$

This measures the percentage of assets being financed by liabilities. Generally speaking, this ratio should be less than 1, indicating adequacy of total assets to finance all debt.

TIP

These ratios indicate the extent to which the business is able to meet the debt obligations from all sources, other than just cashflow, as is the case with liquidity ratios.

Profitability ratios

These ratios will measure your business performance and ultimately indicate the level of success of your operations. More discussion on these measures is detailed in Chapter Four.

HINT

Use gross and net margin calculations to measure and monitor the profitability of your business operations.

Gross margin ratio = $\frac{\text{Gross profit}}{\text{Net income}}$

This measures the percentage of sales dollars remaining (after obtaining or manufacturing the goods sold) available to pay the overhead expenses of the business.

Net margin ratio = $\frac{\text{Net profit}}{\text{Net income}}$

This measures the percentage of sales dollars left after all expenses (including stock), except income taxes. It provides a good opportunity to compare the business's return on income with the performance of similar businesses.

TIP

Comparing your net and gross margin calculations to those of other businesses within the same industry will provide you with comparative information and may highlight possible scope for improvement in your margins.

Management ratios

Management ratios monitor how effectively you are managing your working capital, that is, how quickly you are replacing your stock, how often you are collecting debts outstanding from customers and how often you are paying your suppliers. These calculations provide an average that can be used to improve business performance and measure your business against industry averages. (Refer to Chapter 5 for more detail.)

HINT

Use the number of days for stock, debtors and creditors to calculate the cash conversion rate for your trading. activities.

$$\textbf{Days inventory} = \frac{\textbf{Inventory}}{\textbf{Cost of goods sold}} \times 365$$

This ratio reveals how well your stock is being managed. It is important because it will indicate how quickly stock is being replaced. Usually, the more times inventory can be turned in a given operating cycle, the greater the profit.

$$\textbf{Days debtors} = \frac{\textbf{Debtors}}{\textbf{Net income}} \times 365$$

This ratio indicates how well the cash from customers is being collected - referred to as accounts receivable. If accounts receivables are excessively slow in being converted to cash, the liquidity of your business will be severely affected. (Accounts receivable is the total outstanding amount owed to you by your customers.)

$$\textbf{Days creditors} = \frac{\textbf{Creditors}}{\textbf{Cost of goods sold}} \times 365$$

This ratio indicates how well accounts payable are being managed. If payables are being paid on average before agreed payment terms and/or before debts are being collected, cashflow will be impacted. If payments to suppliers are excessively slow, there is a possibility that the supplier relationships will be damaged.

TIP

Comparing your management ratio calculations to those of other businesses within the same industry will provide you with comparative information that may highlight possible scope for improvement in your trading activities.

Balance sheet ratios

These ratios indicate how efficiently your business is using assets and equity to make a profit.

HINT

Use the return on assets and investment ratios to assess the efficiency of the use of your business resources.

Return on assets = $\dfrac{\textbf{Net profit before tax}}{\textbf{Total assets}}$ **x 100**

This measures how efficiently profits are being generated from the assets employed in the business. The ratio will only have meaning when compared with the ratios of others in similar organisations. A low ratio in comparison with industry averages indicates an inefficient use of business assets.

Return on Investment = $\dfrac{\textbf{Net profit before tax}}{\textbf{Equity}}$ **x 100**

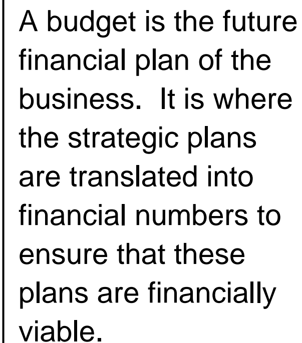
The return on investments (ROI) is perhaps the most important ratio of all as it tells you whether or not all the effort put into the business is, in addition to achieving the strategic objective, returning an appropriate return on the equity generated.

TIP

These ratios will provide an indication of how effective your investment in the business is.

Chapter 3: Budgeting

Budgeting is the tool that develops the strategic plans of the business into a financial statement setting out forecasted income, expenses and investments for a given period. Budgets enable you to evaluate and monitor the effectiveness of these strategic plans as they are implemented and to adapt the plan where necessary.



Most small businesses operate without large cash reserves to draw on; therefore, budgeting will provide the financial information required to assess if your strategic plans will support the ongoing operations. In short, budgeting is the process of planning your finances over a period. Budgeting can also provide an opportunity to plan for several years ahead in an effort to identify changing conditions that may impact on the business operations and cause unexpected financial difficulty.

Good practice budgeting requires the following:

- Preparation of strategic goals
- Budgeted timelines that align to the preparation of financial statements
- Regular comparison of budgets against actual financial results as disclosed in the financial statements
- Scope for amending activities and targets where actual results indicate that budgeted outcomes will not be met

In short, budgets are one of the most important financial statements, as they provide information on the future financial performance of the business and, if planned and managed well, will be the central financial statement that allows you to monitor the financial impact of the implementation of your strategic plans.

Profit and loss budget

A profit and loss budget is an important tool for all businesses because where activities can generate profit, your business will be less reliant on external funding. The budget is a summary of expected income and expenses set against the strategic plans for the budget period. This is usually one year, although, in some cases, the period can be shorter or longer, depending on what you are going to use the budget for.

Although your accountant can be of assistance in the preparation of this budget, it is important that you understand how it has been developed and know how to monitor the outcomes against the prepared budget to ensure your business will achieve the required financial outcomes.

HINT

By preparing a profit and loss budget annually, you will be in a position to determine if your future business plans will support the ongoing activities of your business.

Preparing Profit and Loss Budget

The key to successful preparation of a profit and loss budget is to undertake the process in an orderly manner, involving all key staff and ensuring the goals of the business are clearly understood prior to the preparation. There are two methods of preparing a profit and loss budget:

- **Incremental** – where the previous year's activities are used as the basis for preparation
- **Zero-based** – where all the financials are prepared without consideration of past activities.

For annual budgeting, the preferred method would be incremental, as zero-based would require an enormous amount of dedicated resources and time to prepare. In the case of project- or activity-based budgets, zero-based may be more suitable, particularly for new projects where there is no previous financial data.

An annual budget preparation policy should be documented and followed, and could include some or all of the following steps:

1. Review the approved strategic plan and note all required activities for the budget period
2. Separate activities into existing and new for the new budget period
3. Identify and document all assumptions that have been made for the budget period
4. Review prior year's profit and loss statements by regular periods (monthly, quarterly etc.)
5. Prepare the profit and loss budget for the selected period using all the steps listed above.

TIP

An independent profit and loss budget can be developed for separate projects to assess the financial viability of each project

Assumptions

To ensure your budget will be a useful tool, you need to spend some time planning what you think is going to happen in your business in the future. As you are preparing your estimates on income and expenditure, you will be estimating how your business will operate in the future and these are referred to as assumptions. When determining your assumptions, it would be best to use realistic targets that you believe will be achievable. Using your historic financial information and looking for any trends in this information is a good place to start. Also, any industry information provided by independent reputable companies will give your assumptions credibility. This is particularly useful where you are going to provide your budget to a potential or current lender or investor.

HINT

All assumptions made during the planning process of preparing budgets should be realistic and documented.

Make sure you write down all the assumptions and then establish a financial number that reflects the event. Once you have completed the table of assumptions, attach them to the budget. This way, you will remember what you anticipated happening and, when reviewing your budget against the actual figures, this will help to determine why the actual results may not be the same as your budgeted numbers. When listing your assumptions, if you believe there is some risk the event may not occur, include this detail, together with any actions you could undertake if a particular assumption turns out to be incorrect. That way, you will already have an action plan in place.

Let's return to Joe's Motorbike tyres and see how he is going to set his budget for year two of his business.

Using his first year profit and loss statement, Joe is now going to set some assumptions for the second year of his business.

Assumption Table				
Assumption	**Forecast**	**Source**	**Risk**	**Action**
Sales	Increase by 50%	Forward orders	Sales remain constant or decrease	Review stock holdings and operating expenses Introduce marketing program
Cost of goods	Remain at 60% of sales	Current supplier contract	Stock prices increase	Source new supplier
Salaries	Increase to $19,500 for year	In line with industry standards	Cashflow shortage	Reduce salary expense
Vehicle expense	Purchase vehicle and include running expenses	Required for sales and marketing	Cashflow shortage	Review operational activities to identify possible expense savings

We can see he is now confident that, in the second year, he can increase his sales by 50%. Of course, with increase sales, comes an increase in expenditure to support these sales. He has developed a plan of what the year-two profit and loss statement will look like.

Joe's Motor Bike Tyres
Profit and Loss Statement

	As at end of Year One	As at end of Year Two
Income		
Sales	$52,000	$78,000
Total Sales	$52,000	$78,000
Cost of goods sold		
Opening stock	$ -	$3,120
Stock purchases	$34,320	$49,920
Less closing stock	$3,120	$6,240
Total cost of goods sold(COGS)	$31,200	$46,800
Gross Profit	$20,800	$31,200
Expenses		
Advertising	$500	$1,000
Bank service charges	$120	$200
Insurance	$500	$550
Payroll	$13,000	$19,500
Professional fees (legal, accounting)	$200	$420
Stationery		$250
Utilities & telephone	$800	$880
Vehicle expenses		$2,450
Other: computer software	$480	$100
Expenses total	$15,600	$25,350
Net profit before tax	$5,200	$5,850

Joe will need to monitor his actual results, checking them against this budget, to ensure his plan will be achieved.

TIP

When documenting your assumptions, include both the risk assessment of each assumption and the anticipated action required to match the risk. That way, if actual events do not match your assumptions, you will be well prepared and have an action plan already in place.

Monitoring and Managing your Profit and Loss Budget

There are a number of ways that the profit and loss budget can be managed. As noted at in Chapter 1, it is important that regular preparations of financial statements – in particular the profit and loss statement – are prepared so that the actual activities can be compared with the budget. Standard practice would be to prepare monthly statements; however, for smaller businesses, quarterly preparation and comparison may be suitable.

Where the profit and loss statement is prepared on a monthly basis, the budget will need to be separated into months for the budget period. At the end of each month, the actual results are compared with the budgeted results and any variances noted and analysed. Such variances should be noted on the reports and explanations provided. All variances should be categorised as either a "timing" or "permanent" variance.

HINT

Remember, the more regular the reports, the quicker operations can be reviewed for financial impact and action can be implemented immediately where required.

A timing variance is where the estimated result did not occur but is still expected to happen at some point in the future.

A permanent variance is where the expected event is not likely to occur at all.

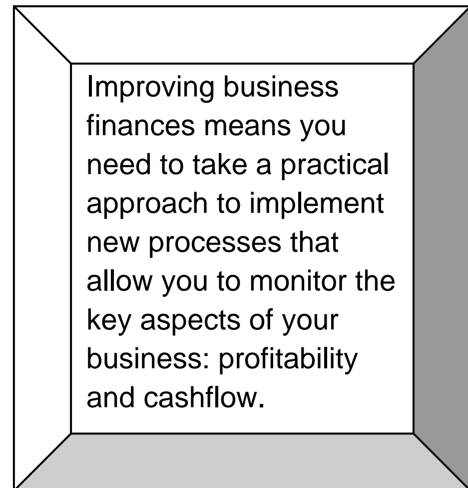
The power of this analysis is that each variance is documented for future reference and, where required, action can be taken to counteract future variances or implement new or improved activities to ensure the strategic goals that underlie the budget can still be achieved.

TIP

Regular review of budget against actual results will provide information on whether your business is on track to achieve the plans formulated when you first prepared your budget.

Improving Business Finances

Now you have been introduced to the basics of business finance, you can use these tools to improve the financial management of your business. Proactive management of the financial position of your business will ensure that any issues encountered will be identified early so that appropriate action to rectify the situation can be taken in a timely manner.

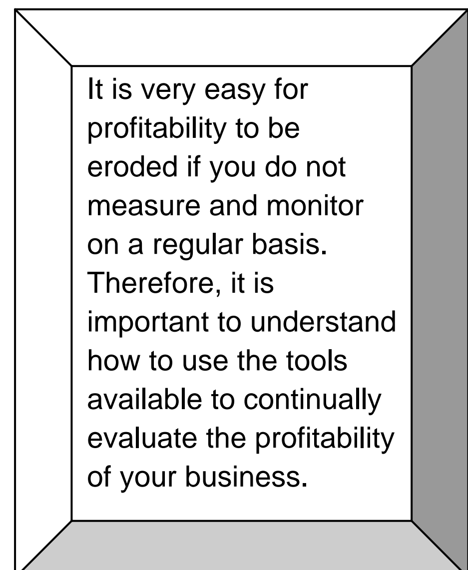


Through the use of the financial information discussed in the first section of the guide, and by implementing the processes introduced in this section, you will be well on the way to achieving good financial management for your business.

Profitability and cashflow are the key areas that should be monitored on an ongoing basis to help ensure that your business prospers. This section of the guide presents a number of easy-to-understand procedures and tools that can assist in maintaining profitability and improving cashflow.

Managing the business finances is all about taking a practical approach to maintaining profitability and improving cashflow, together with having the discipline to continually monitor and update the financial information as circumstances change.

Chapter 4: Maintaining profitability



One of the most important issues for any business is maintaining profitability. A profitable business will ensure you can manage your business in line with your overall strategic objective, whether it is to grow the business, sell at a later date, or some other objective.

In this chapter, we look at three useful tools that will help you monitor the profitability of your business. We also discuss how discounting can affect your profit, and of course, we look at managing the expenses of the business to maintain profitability.

Profitability measures

Once you have a profit and loss statement, you can use the tools explained below to ensure you know:

- That your profits are not being eroded by increasing prices in stock or expenses – **Margin**
- How to set new selling price when stock costs increase – **Mark-up**
- How much you need to sell before the business is making a profit – **Break-even analysis**

HINT

Using the profitability measures provided will ensure you are aware of any reduction in profit as it occurs and understand what level of sales is needed to make sure the business will generate a profit.

Margin

There are two margins that need to be considered when monitoring your profitability: gross and net. For a service business, only net margin would be relevant, as it is unlikely there would be a direct cost of service provided.

Gross margin is the sales dollars left after subtracting the cost of goods sold from net sales. What do we mean by "net sales"? This is all the sales dollars less any discounts that have been given to the customer and commissions paid to sales representatives. By knowing what your gross margin is, you can be sure that the price set for your goods will be higher than the cost incurred to buy or manufacture the goods (gross margin is not commonly used for service businesses, as they most often do not have "cost of goods") and you have enough money left over to pay expenses and, hopefully, make a profit.

Gross margin can be expressed either in dollar value (gross profit) or in a percentage value that measures the percentage of sales dollars remaining (after obtaining or manufacturing the goods sold) available to pay the overhead expenses of the company. (The percentage value is particularly useful if you are comparing your business with other businesses in your industry or with past performance of your business).

Gross profit $ = Net sales less cost of goods sold	Gross margin % = $\frac{\text{Gross profit dollars}}{\text{Net sales dollars}}$ x 100

Net Margin is the sales dollars left after subtracting both the cost of goods sold and the overhead expenses. The net margin will tell you what profit will be made before you pay any tax. Tax is not included because tax rates and tax liabilities vary from business to business for a wide variety of reasons, which means that making comparisons after taxes may not provide useful information. The margin can be expressed either in dollar value (net profit) or in percentage value. (The percentage value is particularly useful if you are comparing your business with other businesses in your industry or with past performance of your business).

Net profit $ = Net sales less gross profit	Net margin % = $\frac{\text{Net profit dollars}}{\text{Net sales dollars}}$ X 100

Mark-up

Mark-up is the amount you sell your goods above what it cost to purchase or manufacture those goods. It is generally only a meaningful figure when referring to the sale of products rather than services. It can be useful to use mark-up calculation to ensure you set the selling price at a level that covers all costs incurred with the sale.

Mark-up is calculated as follows:

$$\text{Percentage value} = \frac{\text{Sales less cost of goods sold}}{\text{Cost of goods sold}} \times 100$$

Break-even Calculation

The break-even calculation shows how many sales have to be made, in either dollars or units, before all the expenses are covered and actual profit begins.

This simple calculation is used to find where profit really starts. The break-even point is calculated as follows:

$$\textbf{Break-even \$} = \frac{\textbf{Expenses}}{1 \text{ less } \frac{\textbf{(Cost of Goods Sold)}}{\textbf{Net Sales}}}$$

$$\textbf{Break-even \%} = \frac{\textbf{Expenses}}{\textbf{Unit selling price less (Unit cost to produce)}}$$

Refer to the Small Business Victoria website link below for more information on break-even calculations.

http://www.business.vic.gov.au/busvicwr/_assets/main/lib60208/sbv_infosheet_cash_flow_break_even.pdf

If we remember Joe's profit and loss statement for year one (in Chapter 1), we can use this to calculate the profitability measures for his business.

Joe's Motorbike Tyres

Profit and Loss Statement

Year One

		%
Sales	$52,000	100
Less cost of goods sold	$31,200	60
Gross profit	$20,800	40
Less operating expenses	$15,600	30
Net profit	$5,200	10

$$\text{Mark-up \%} = \frac{\text{Sales less cost of goods sold}}{\text{Cost of goods sold}} \times 100$$

$$= \frac{\$52{,}000 \text{ less } \$31{,}200}{\$31{,}200} \times 100$$

$$= 66.67\%$$

$$\text{Gross margin} = \frac{\text{Net sales – cost of goods sold}}{\text{Net sales}} \times 100$$

$$= \frac{\$52{,}000 \text{ less } \$31{,}200}{\$52{,}000} \times 100$$

$$= 40\%$$

$$\text{Net margin \%} = \frac{\text{Net profit (dollars)}}{\text{Net sales (dollars)}} \times 100$$

$$= \frac{\$5{,}200}{\$52{,}000} \times 100$$

$$= 10\%$$

$$\text{Break-even \$} = \frac{\text{Expenses}}{1 \text{ less } \dfrac{\text{(Cost of goods sold)}}{\text{(Net sales)}}}$$

$$= \frac{\$15{,}600}{1 \text{ less } \dfrac{(\$31{,}200)}{(\$52{,}000)}}$$

$$= \frac{\$15{,}600}{1 \text{ less } 0.6}$$

= $39,000 sales needed before any profit will be made

Summary of Joe's Motorbike Tyres Profitability Measures

Mark-up	66.67%
Gross margin	40.00%
Net margin	10.00%
Break-even	$39,000

TIP

Compare your profitability measures to those of businesses within the same industry to ensure you are being competitive and achieving maximum profit potential.

Discounting sales

HINT

You may like to consider offering your customers add-on services as an alternative to offering discounts

Discounting your goods or services to entice customers to purchase may erode your profits. Of course, some discounting can be beneficial; however, **before** you decide to offer discounts, it is important to understand the impact discounting will have on your profits. Alternatives such as add-on products or services may deliver more dollars of gross profit to the business and should be considered before deciding to offer discounts.

In the previous section, we discussed sales "net" of discounts. When you discount, you are effectively offering your goods or services at a reduced selling price. Where discounts are offered, you will need to sell more goods in order to achieve your gross margin.

Let's return to Joe's Motorbike Tyres. He is considering offering a 5% discount to encourage more sales. Joe needs to keep his gross margin at 40% to ensure he reaches his profit goal. As the table below shows, if he decides to discount his tyres by 5%, he will need to increase his sales volume by 14.3%.

The Effect of Discounting

	And your present Gross Margin (%) is						
	10%	15%	20%	25%	30%	35%	40%
If you cut your prices by...							
5%	100.0%	50.0%	33.3%	25.0%	20.0%	16.7%	14.3%
6%	150.0%	66.7%	42.9%	31.6%	25.0%	20.7%	17.6%
8%	400.0%	114.3%	66.7%	47.1%	36.4%	29.6%	25.0%
10%		200.0%	100.0%	66.7%	50.0%	40.0%	33.3%
12%		400.0%	150.0%	92.3%	66.7%	52.2%	42.9%
15%			300.0%	150.0%	100.0%	75.0%	60.0%

If we put some numbers to this, we can see the results in the box below.

Joe's Motorbike Tyres

Joe wants to discount his tyres by 5%. To maintain gross margin of 40%, he will need to increase sales units by 14.3%.

Joe is currently selling		1000 tyres		
Increase volume by 14.3%	=	1000 + (1000 x 0.143)	=	1,143 tyres

To maintain gross margin (and achieve target profit), Joe will need to sell

1,143 tyres if he sells at 5% discount.

The same would apply to a service business; if selling price is cut by 5% and the net margin is 30%, sales will need to increase by 20% to ensure all operating costs are covered.

TIP

Always calculate the impact on profitability before offering discounts

Expense management

Good management of general expenses by the business will contribute to increasing profits. By monitoring business expenses, you may be able to identify where costs are increasing and take action to ensure you maintain your net profit margin.

When monitoring expenses, don't forget to identify the expenditure that keeps you in business (e.g. presentation of premises, marketing, staff training) and keep these at sustainable levels.

HINT

Keeping a close eye on your expenses will ensure you maintain the profitability of the business.

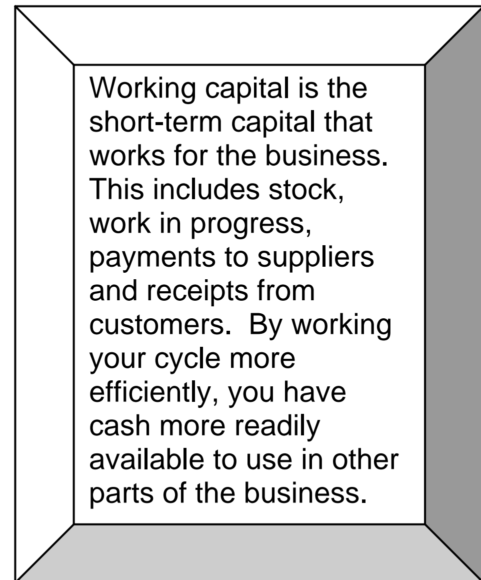
To maintain constant rigour on expenses, continual review will help identify where costs are getting out of hand. Don't forget to use the profitability measures, as they are the simplest way to quickly see if your profits are being eroded. Some other ideas to manage expenses are to consider joining forces with other businesses to benefit from group buying, investigate using companies that provide access to discount services for bulk orders, and to seek quotes for different services to ensure you are paying the best possible price for your expenses. Often, if you are a member of an industry association, the association may have established relationships with service providers such as insurance companies and you may be able to access discounted services or products through your membership.

However, be careful not to focus too much on individual expenses. The dollars you may save from such an exercise may be outweighed by the cost of your time and the aggravation such a focus may cause your staff, suppliers or customers.

TIP

Look for opportunities to join with other businesses for group buying that can provide discounts on your expenses.

Chapter 5: Improving Cashflow


Working capital is the short-term capital that works for the business. This includes stock, work in progress, payments to suppliers and receipts from customers. By working your cycle more efficiently, you have cash more readily available to use in other parts of the business.

One of the most important aspects of running a business is to ensure there is adequate cashflow to meet all of the short-term obligations. The survival of your business will depend on this. Referred to as working capital management, this is all about setting up strategies to ensure there is enough cash in the business to operate on a day-to-day basis without facing a cash crisis.

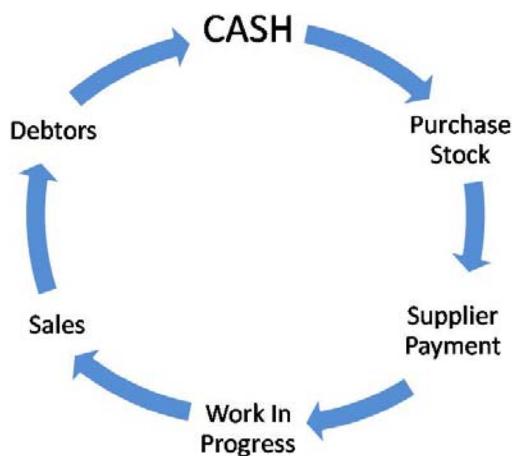
Working capital in business is made up of these core components:

- Stock management
- Payment of suppliers (creditor payments)
- Work in progress
- Collection of cash from customers (debtor collection).

Often referred to as "the working capital cycle", this is really about the length of time it takes from using your cash to purchase stock (or perhaps getting it from a supplier on credit terms), and using the stock, possibly for a manufacturing purpose (hence creating part of the cycle called "work in progress"), to securing the sale and receiving the cash.

Here is a diagram of the working capital cycle:

Manufacturer or Product Provider



Service Provider

Between each stage of the working capital cycle, there is a time delay. For some businesses, there could be a substantial length of time to make and sell the product. In these enterprises, a large amount of working capital will be required to survive. Others may receive their cash very quickly after paying out for stock, perhaps even before they have paid their bills. Service businesses will not need to pay out cash for stock and, therefore, will need less working capital.

The key to successful cash management is watching carefully all the steps in the working capital cycle. The quicker the cycle turns, the faster you have converted your trading operations back into available cash, which means you will have increased the liquidity in your business and will be less reliant on cash or extended terms from external stakeholders such as banks, customers and suppliers.

There are many ways you can make the working capital cycle move faster. The following sections provide information about how you can make the cycle move more quickly and improve the cashflow in your business.

Managing stock

Stock management is about having the right level of stock to satisfy the needs of your customers and managing the stock to identify excess or aged stock.

Of course, stock has to be funded, either from existing cash in the business or from borrowings, so it is important the stock levels are managed so that they use up the minimum financial resources necessary. This does not necessarily mean keeping low levels of stock, but rather ensuring that stock is held for the shortest possible time, which means it will be converted into cash quickly. (Too little stock can impact sales, so the key is to find the appropriate level, which will change over time).

However, maintaining stock comes with a cost. It is estimated that holding stock can cost anything between ten and thirty percent of the value of the stock. This includes storage, insurance, keeping accurate tracking records and proper controls to avoid theft.

HINT

Setting up good stock control procedures will ensure cash is not tied up in holding unnecessary stock.

Efficient stock control involves three elements:

- Stock review
- Buying policy
- Operational issues.

The following checklist will help you determine what measures for stock control you may need or can use to improve to your existing procedures.

Checklist for Managing Stock	
1. Stock Review	
Action	**Description**
List all stock held	Determine the current level, what items are held and the value of stock on hand.
Review sales of stock	Look at sales records to find out which items are good sellers and which are slow moving. Don't forget to look at seasonal trends. A focus on the good sellers should, if you manage your debtors well, increase cashflow. Work out which items of stock sold make the highest gross margin. This is important, as you may then be able to improve profit by focusing more energy on these sales.
List slow-moving, aged and excess stock	Make a list of slow-moving, aged and excess stock items and develop an action plan to move this stock immediately, even if it is at lower than the cost of the item. This will generate cash to invest in new stock that will move more quickly and free up display space for faster moving stock.
Update stock records	Update your stock records with the current levels and then implement a policy to track all movement of stock. This will help ensure stock is re-ordered only when needed, and will highlight any theft or fraud that may occur.

2. Buying Policy	
Action	**Description**
Understand what is "core" stock	Identify stock that you simply must never run out of in order to maintain sales momentum and ensure customers are never disappointed over the basic products in your range.
Tighten the buying of stock	Know the volume sales per stock item. This will help you buy the right amount. Carrying too little stock may discourage customers, as you may not be able to satisfy their needs immediately, and carrying too much stock means you are tying up cash that could be put to better use.
Negotiate with suppliers	Negotiate deals with suppliers, but avoid volume-based discounts. When money is tight, there is no point investing in next month's stock without good reason. Instead of volume discounts, try to negotiate discounts for prompt settlement (unless your cash position is poor) or negotiate for smaller and more frequent deliveries from your suppliers to smooth out your cashflow.
Beware of discounts offered	Don't let discount prices drive your stock-buying decisions. Buy stock you can sell at a profit in a reasonable time frame.

3. Operational Issues	
Issue	**Description**
Supplier service	Suppliers can assist in stock management by providing access to stock only when you need it (called JIT – just in time) and by providing good delivery service. By ordering less stock more frequently and arranging better delivery schedules, you can reduce stock quantities, saving valuable cash resources and improving liquidity without reducing sales.
Advertising and promotion	Before launching a promotion, ensure you have adequate stock or can source adequate stock. If you have taken on larger than normal quantities, make sure you have a back-up plan if they don't sell during the promotion.
Sales policy	This can have a strong influence on stock levels and should be managed with a view not only to maximising sales, but also to minimising investment in working capital. This can be achieved by directing policy towards a higher turnover of goods, selling goods bought at bargain prices faster, and clearing slow-moving items.
Customer delivery	Ensuring goods are delivered to the customer faster means the stock is moved and the cash for the sale will come in more quickly.

TIPS FOR IMPROVING STOCK CONTROL

- For fast-moving stock, negotiate with suppliers for delivery when required (called Just In Time – JIT), eliminating the need to hold a large store of stock to meet customer demand.
- For aged and excess stock, either sell at whatever price to move it, or use as a donation to a charity or community group. (Don't forget to advertise that you have made a donation!)
- Keep accurate stock records and match the records to a physical count regularly – at least once a year. However, if there are large variances between the records and physical count, do the count more regularly until the issues are identified and corrected.
- Understand your stock: which ones move quickly, which ones contribute the highest gross margin, and which ones are seasonal etc. This will help you know how much of each line of stock to keep on hand and when re-order is required.
- Use your financial system to track stock items. This will help with both:
    - Automating re-order requirements
    - Matching different stock items to sales and easily identifying high margin sales.
- Keeping good control over your stock holdings will ensure you keep aged and excess stocks to a minimum and reduce the risk of theft, while still having adequate stock levels to meet your customers, needs.

Using Numbers to Manage Stock

Days inventory ratio

This ratio reveals how well your stock is being managed. It is important because it will indicate how quickly stock is being replaced, and the more times inventory can be "turned" (replaced) in a given operating cycle, the greater the profit.

Days inventory ratio is calculated as follows:

$$\text{Days Inventory} = \frac{\text{Stock on hand}}{\text{Cost of Goods Sold}} \times 365$$

Joe's Motorbike Tyres

$$\text{Days inventory} = \frac{\$3,120}{\$31,200} \times 365 = 36.5 \text{ days}$$

This calculation shows that, on average, Joe holds his stock for 36.5 days.

Stock turn

This calculation shows the effectiveness of your planning of stock holdings. A low stock-turn rate will show you are not moving stock, which could lead to excess or aged stock and, of course, higher holding costs. A high stock-turn rate could indicate you run the risk of not having adequate stock on hand to supply customers' needs.

Stock turn is calculated as follows:

$$\text{Stock Turn} = \frac{\text{Cost of Goods Sold}}{\text{Stock on hand}}$$

Joe's Motorbike Tyres

$$\text{Stock turn} = \frac{\$31,200}{\$3,120} = 10 \text{ times}$$

This calculation shows that, on average, Joe turns his stock over 10 times per year.

The day's inventory and stock-turn calculations should be compared with industry averages to provide the most useful information. Comparing these measures regularly with previous periods in your business will also provide information on the effectiveness of stock management within your business.

Managing payments to suppliers

The payment of suppliers will impact your cashflow. Often, start-up businesses will have to pay suppliers in cash on delivery of goods or services, because they do not have a trading history. The supplier will not be prepared to provide the goods or services on credit because they will not be sure if the business will be profitable or still operating in the future. Once your business is up and running, there is likely to be some scope to negotiate with your suppliers so that you can pay on credit and free up cashflow.

Making full use of your payment terms with your supplier is effectively an interest-free loan. Therefore, it is important to manage your suppliers and the payments to them in the same way as you manage the other key components of the working capital cycle. Effective management of suppliers and the payments to them consists of three key elements:

- Supplier selection
- Payment terms
- Managing relationships.

HINT

Setting up good management procedures will ensure you get the most out of your relationship with suppliers.

The following checklist will help you review what procedures you may need to improve your existing supplier procedures:

Checklist for Managing Suppliers & Payments to Suppliers	
1. Supplier selection	
Action	**Description**
Prioritise	Determine your priorities in relation to your suppliers. Is it quality, reliability, returns policy, price, terms, or a combination of some or all of these factors?
Determine preferred suppliers	Prepare a list of preferred suppliers.
Check references	Undertake credit and trade reference checks for each supplier on the list.
Select supplier/s	Select supplier/s based on your priorities and results from credit and trade checks.
Establish alternative supplier/s	If you have one main supplier, be sure you have an agreement in place with an alternative supplier to cover any risk that the chosen supplier cannot provide the agreed service at any time.
Review regularly	Monitor the selected supplier/s and regularly review their performance against your priorities. (Often, the priorities change as the business grows.)

2. Payment terms	
Action	**Description**
Negotiate terms	Agree payment terms with suppliers before entering into the transaction.
Include terms on the order	Document standard payment terms on each purchase order.
Consider discount benefit	Calculate the benefit of taking a discount for early payment.
Pay on terms	Ensure all suppliers are paid on agreed terms, not earlier and not too late. (Check this on a regular basis.)
Have damaged goods procedures	Have an agreed process in place for where damaged goods or unsuitable goods are supplied. Do not withhold payment without communicating to the supplier that there is an issue.
Review terms regularly	Review the terms with each supplier regularly. If you find an alternative supplier that can provide better terms, first discuss this with your existing supplier before changing over. They may be able to match this offer and will appreciate the loyalty you have shown.

3. Managing relationships with suppliers	
Action	**Description**
Meet regularly	Meet regularly with main suppliers to discuss the progress of your business. (They are often able to assist with increased credit terms, new product etc.)
Adhere to payment terms	Ensure agreed payment terms are adhered to.
Have a non-payment process	Ensure there are processes in place for when suppliers are not paid on time i.e. they can contact someone to discuss the situation.
Communicate	Communicate with suppliers when payment needs to be delayed and, if possible, set up an agreed payment arrangement, and make sure you stick to it. Summarise this agreement in writing and ensure the senior finance person (or owner etc) receives a copy
Be a good customer	To maintain good relationships with key suppliers, be seen as a solid, reliable customer.

TIPS FOR IMPROVING SUPPLIER PAYMENTS

- Extend payment terms. Lengthening the payment from 30 to 45 days may help to smooth out fluctuations in cashflows.
- Some larger companies (such as utilities) may accept quarterly payments, which can help in forecasting cashflow requirements.
- Payment terms should specify that payment terms commence from complete delivery, as opposed to part delivery. This should also include goods or services that have not been provided as agreed.
- Where goods are returned, either:
  - a new invoice should be raised, and this is the initiation of the payment terms, or
  - disputed invoices are held over until a credit note is received.
- Initiate a structured payment run, usually once a month (i.e. on the last day of the month) and stick to it.
- Ensure your systems have good controls so that suppliers are not:
  - paid early. Where financial systems are used, ensure payment date is automated from approved supplier details and no change to the automated date is possible without authorisation.
  - over paid. All received goods must be checked against purchase orders and the totals on invoices checked.
  - paid twice. Pay only on statement.
- Continually review supplier contracts for opportunities such as:
  - improved pricing
  - effective discounting
  - improved delivery. (You will not need to order so early and hence will be able to defer payment.)

Using Numbers to Manage Payments to Suppliers

Days creditors ratio

This ratio indicates how well accounts payable (payments to suppliers) is being managed. If these payments are being paid, on average, before agreed payment terms, cashflow may be impacted. If payments to suppliers are excessively slow, there is a possibility relationships with suppliers will be damaged.

The days creditors ratio is calculated as follows:

$$\text{Days creditors} = \frac{\text{Accounts payable}}{\text{Stock on hand}} \times 365$$

Note: Accounts payable is the amount that is owed to your suppliers at the time of the calculation.

Joe's Motorbike Tyres

$$\text{Days creditors} = \frac{\$4{,}120}{\$52{,}000} \times 365 = 28.92 \text{ days}$$

This calculation shows that Joe pays his suppliers on average every 29 days.

Managing work in progress

Work in progress is where an order has been taken from the customer and you are in the process of "working" to complete the order. Of course, in most circumstances, there will be many orders in progress, and so you will need good management systems in place for efficient execution of customer orders. Work in progress is often thought to be only relevant in manufacturing business; however, some retail and service businesses will also have a form of work in progress – the time from order from customer to delivery means that the work is in progress.

HINT

The key to managing work in progress is to have a good record-keeping system.

Managing work in progress is important because the quicker the job can be completed, the earlier the invoice can be raised and hence the cash received for the job.

The following checklist will assist you in comparing your work-in-progress procedures and may help to identify some improvements.

Checklist for Managing Work in Progress	
Action	**Description**
Record all details at order	Ensure all orders are recorded when taken and all relevant details are noted, such as when the order is due, any payment received (e.g. deposit), any progress payments to be invoiced, how long the job takes to complete, and any additional costs incurred in completing the job.
Track progress of out-standing orders	Have procedures in place to track all outstanding orders and rank them by priority. The procedures should highlight any actual or potential delays and have steps outlined for action when delays occur.
Invoice on delivery	When an order is completed, ensure the invoice is raised and sent with the goods.
Use records for cash-flow forecasting	The record-keeping system should provide details of expected completion, delivery, and invoice date, and therefore provide information on cash receipt to assist in cashflow forecasting.

TIPS FOR IMPROVING WORK IN PROGRESS

- Only order stock when you are ready to use it, effectively reducing the number of days held (and hence paid) before production begins.
- Identify any bottlenecks in the production process and look for improvements.
- Look at the process, including the physical layout of goods, and identify possible improvements to speed up the movement through the work–in-progress stage.
- Before accepting the order, ensure you know how much stock you need to have on hand to complete the order. Delay in receiving goods is delay in preparing the sale.
- Review work-in-progress procedures annually to identify possible procedures or technology that could improve the process.
- Where specific materials are required for the customer order (e.g. fabric for covering a couch), include in your order agreement that the customer pays a deposit up front before the order is commenced.

Managing debtors

Sales income is a cashflow driver of all businesses and converting the sale into cash is one of the most important processes in any business. Where sales are offered on credit, financial systems will refer to the amount outstanding as a “debtor”. Managing the payments due from debtors can consume a lot of wasted effort if proper controls and procedures are not put in place at the outset.

Your customers are your key to business success; however, until you receive the cash for the sale, effectively you have given a donation to your customers! So it is important to manage all outstanding payments from your customers and ensure you have good procedures in place to encourage your customers to pay the correct amount and on time.

HINT

Ensure you have good procedures in place to encourage prompt payment.

Efficient debtor collection procedures include the following:

- Credit controls
- Payment terms
- Managing customer relationships.

The following checklist can be used to compare your existing procedures for collecting outstanding amounts from your customers and help identify possible improvements:

Checklist for Managing Debtors	
1. Set up credit controls	
Action	**Description**
Record customer credit check	Have a system in place that documents each credit check for all new customers to ensure the process has been properly undertaken.
Rank all customers according to credit risk	This could by the length of time they have been in business, the quality of the credit check, the credit limit allowed for each customer etc
Set credit limits	Set appropriate credit limits for each customer. The limit should be set in accordance with the credit-risk rating as set out above.
Regularly review credit checks	During tough times, some customers’ credit status may change.
Record customers’ limit usage	Make sure your system tracks customers’ outstanding credit and notifies relevant staff if the limit has been exceeded. Ensure this notification happens before the next sale.
Put policies in place for exceeded limits	Document procedures to be undertaken when a credit limit is exceeded and ensure all relevant staff are aware of what needs to be done.

2. Establish payment terms	
Action	**Description**
Include terms on invoice	Document standard payment terms on each invoice.
Communicate terms to all staff	Ensure all staff (including sales representatives) are aware of the payment terms and that they stick to them.
Have late payment procedures	Implement systems to ensure all payment terms are met. Send out regular reminders and follow up on late payments.
Manage returned goods	Have a policy and process in place for returned goods to ensure payment is not delayed for any length of time.

3. Managing customer relationships	
Action	**Description**
Meet regularly	Meet regularly with your customers, particularly key customers. Sometimes, visiting their premises will help you understand their business requirements and financial position.
Review payment terms	Regularly review the actual payment and agreed terms for each customer. If you find a customer is continually paying outside the agreed terms, meet and discuss the issues.
Non-payment process	Ensure there are processes in place for customers when products or services are not provided as expected (returned goods). Have a policy that covers how to correct this type of situation.
Communicate	Where an order or delivery is going to be delayed, communicate with the customer and discuss alternative solutions. Only agree a completion date with the customer if you are certain you can meet the deadline.
Be a good supplier	Be seen as a solid, dependable supplier to your customers.

TIPS FOR IMPROVING DEBTOR COLLECTIONS

- Send out invoices as soon as work is completed, not at the end of the week or month.
- Provide incentives to pay early (eg a discount, but know the impact on profit margin.)
- Make it easy to pay – direct credit arrangements, EFTPOS or credit card.
- Where commission is paid to sales staff, pay commission on amounts collected, rather than on total sales amount booked.
- Run regular reports to identify when payments are due (aged debtors report).
- Identify slow paying customers and make contact early to discuss any issues (e.g. faulty goods, inadequate service, inability to pay).
- Monitor non-paying customers and keep in regular contact.
- Make arrangements for non-paying customers (payment plan to clear the debt).
- Have a policy to stop supplying a customer until all debts are cleared.
- Send letters of demand for long outstanding debts.
- If necessary, use a professional debt collector.
- Remember, a good customer is only one that pays. If you are not collecting the cash from your customer, then your organisation is funding your customer's business as well as your own.
- Consider "sacking" a customer if they are unreliable with payments.

Using Numbers to Manage Payments from Customers

Days debtors ratio

This ratio indicates how well the cash from customers is being collected. Referred to as accounts receivable in accounting terms, this is the total outstanding amount owed to you by your customers. If these receivables are not collected reasonably in accordance with their terms, you should rethink the collection policy. If receivables are excessively slow in being converted to cash, the liquidity of your business will be severely affected.

The days debtors ratio is calculated as follows:

$$\text{Days debtors} = \frac{\text{Accounts receivable}}{\text{Sales revenue}} \times 365$$

Joe's Motorbike Tyres

$$\text{Days debtors} = \frac{\$18{,}000}{\$52{,}000} \times 365 = 126 \text{ days}$$

This calculation shows that, on average, Joe collects from his debtors every 126 days.

Working capital cycle – cash conversion rate

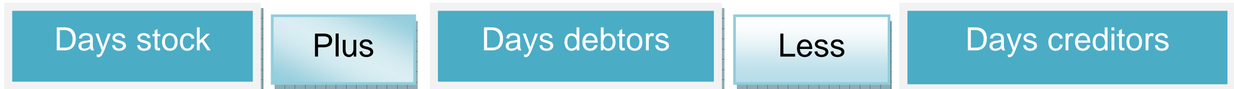
The overall number of days to convert your trade from the cash outflow at the beginning of the working capital cycle to cash received at the end of the cycle can be calculated by the cash conversion rate.

HINT

Calculate the cash conversion rate and compare this with the standards within your industry. Using each of the tips in the sections above, identify which areas of the cycle are problematic and prepare an action plan to improve the cash conversion rate.

Cash Conversion Rate Calculation

The cash conversion rate is calculated as:



Joe's Motorbike Tyres
Cash Conversion Rate

Days Stock 36.5 Plus Days Debtors 126 Less Days Creditors 28.9

Equals Cash Conversion Rate 133.6

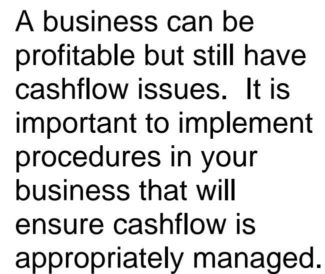
This calculation shows that for Joe's Motorbike tyres the working capital cycle takes 133.6 days from the start of the transaction to when the transaction is completed and converted back to cash.

TIP

Regularly calculate your cash conversion rate and implement improvement to your working capital to free up idle cash that is not being used within the business. This will reduce the need to borrow additional funds to support the operations of the business, decrease reliance on funds from financiers, and reduce any interest expense incurred.

Chapter 6: Managing Cashflow

Cash and Profit



You know now that profit is made from selling your goods or services for a price higher than what it cost to make or deliver to your customers. Cash of course is generated from these transactions, as well as other activities that the business may undertake (such as selling assets). The key to a successful business is good profitability and adequate cashflow.

This means, if you manage your margins properly, your trading should always be profitable and hence have positive cashflow, right? Wrong! A business can be profitable but still encounter cashflow issues. How does this happen? Well, it's all about timing. Profit of a transaction is calculated when the sale is made. If you are in a business that offers goods or services on credit, then the profit is generally assessed at the time of the sale; however, you may not receive the cash until some time later.

There are two ways the transaction can be recorded: either on the cash basis or accrual basis. Let's explain. When working out if your transaction is going to be profitable, these are probably the questions you will need to answer:

- How much will it cost you to buy or make the product, or provide the service (hours paid)?
- What is a realistic price that your customer will be willing to pay?
- What do your competitors charge for the same or similar products or services?

The next step is to compare the price you will receive with the cost paid, and if price is higher than cost, the transaction is profitable.

Again, let's go back to Joe's motorbike tyres profit and loss statement, which we looked at in Chapter 1.

Joe's Motorbike Tyres	
Profit and Loss Statement Year One	
Sales	$52,000
Less cost of goods sold	$31,200
Gross profit	$20,800
Less operating expenses	$15,600
Net profit	$5,200

When we look at Joe's profit and loss statement, we can see he will make $20,800 in gross profit. This way of recording the transaction is called accrual accounting, that is, sales are recorded when made, rather than when cash is collected. This is the most effective way of matching all costs to the transaction and makes it easier to see clearly how much profit is generated from the transaction.

Using Joe's example, let's assume he sells 500 tyres at $52 per tyre to a motorbike manufacturer on thirty days' credit, meaning that he will receive $26,000 from this customer at the end of month one. He also is able to export 200 tyres at $52 per tyre, which means the payment of $10,400 from the overseas customer is not received until the second month from delivery. The balance of his stock will be sold later in the year. All of the tyres have been imported at the beginning of the year and cost $34,320 in total, which was paid at the end of the first month of trading.

When we look at the cashflows from Joe's sales, this is when it becomes clear that the cashflows will not equal the profit until the total transaction in completed, that is, when all the money is received from all the sales.

Transaction		**Cash Movement**		
		Month 1	Month 2	Months 3 to 12
Sales	$52,000	$26,000	$10,400	$15,600
Payment for stock	$34,320	($34,320)		
Gross profit	$20,800	($10,400)	$10,400	$15,600
Cash balance		($10,400)	Nil	$15,600

In month 1, Joe only collects $26,000 from sales, but has to buy all the motorbike tyres in the same month. He only receives the cash for sales of a further 200 tyres in month 2 and the rest through the balance of the year. So the above table shows that at the end of month 1, he will need an extra $10,400 to cover the purchase of the tyres, and, by the end of the year, his bank balance will match his gross profit. Of course, he will also have to cover the operating expenses throughout the year, which have not been included in the above table.

TIP

The timing of when cash is received is the most important issue when managing cashflow.

Cashflow drivers in your business

HINT

Cashflow is the lifeblood of every business. A profitable business can still suffer from shortages in cash, so it is important to understand what "drives" your cashflow.

Even where your business is profitable, managing cashflow in your business can be very important. By identifying what "drives" the cashflow in your business, it will be easier to manage your cashflow. What do we mean by "drivers" of cashflow? They are the things in your business that affect your cashflow the most. For most small businesses, this will be sales. However, for some businesses, it could be something else. Let's look at the most common key drivers of cashflow and this will help you determine the key drivers of cashflow in your business.

Accounts Receivable (Debt Collection)

For all businesses, sales are important. After all, this is what ultimately generates profits for your business. From Joe's example on the previous page, it can be seen that the collection of cash from sales is critical to ensuring he has cash in the bank. So, if sales are the key issue for you to manage cashflow, then you must have good procedures in place to ensure you can convert the sale to cash as quickly as possible. The best way to do this is to manage the collection of cash from your customers using the checklist in the previous chapter.

Accounts Payable (Creditor Payments)

Where the supply of stock or services is critical to your business, then managing your supplier relationships will be important. If you have only one or two suppliers that can provide your business with stock or services, then ensuring you pay them on time and maintain a good relationship will be critical. If this is the case, then payments of accounts can be a key driver of your cashflow. (For tips on managing supplier payments, refer to the previous chapter.)

Stock

For some businesses, the supply of goods is very important in ensuring the supply of quality stock in time to meet customer requirements. To determine if this is a key driver, you may like to consider whether the supply of goods is critical to making your business operate. If it is, then maintaining the right amount of stock will have an impact on cashflow.

Capital Expenditure

Where a business relies on having the most up-to-date technology, whether this is new equipment or resources, in order to keep market share, spending on capital expenditure can be a key driver of cashflow. An example may be a research and development business, where they need to keep the most up-to-date equipment to develop the most current product or service. In this case, the business will need to have enough cashflow to support this capital expenditure.

TIP

The importance of knowing what the key drivers of your cashflow are should not be under-estimated. In order to maintain adequate cashflow, these drivers should be a priority for your business and be well managed.

Cashflow forecasting

A cashflow forecast is the most important tool for business; cashflow planning is essential for business success. The forecast will predict the ability of your business to create the cash necessary for expansion or to support the operations of the business. It will also indicate any cashflow gaps the business may experience – periods when cash outflows exceed cash inflows. It uses estimated or real figures you collect and add to a simple worksheet from the day you start the business. You can also develop a cashflow forecast from your existing information if you are already in business. After twelve months, you'll have a good idea as to what your cash balance will be, month by month for your next year of operation.

HINT

Remember that cashflow is all about timing and the flow of cash, so when preparing your cashflow forecast, make sure you are as accurate as possible on the timing of the cashflows.

There are a few ways to use a cashflow forecast as a planning tool:

- In short-term planning, to see where more cash than usual is needed in a month, for example, when several large annual bills are due, and the cash in the bank is likely to be low
- In business planning (long-term planning) to find where cashflow could break the business, especially when you want to expand. For example, a seasonal swimwear retailer, after months of quiet winter trading with a low cashflow, has to buy new season's stock, employ extra staff and advertise. But they may also be planning to extend into the shop next door. After several lean months, the cash supply may be at its lowest, even without the added expense of the new premises, so the cashflow would need careful planning.

The easiest way to prepare a cashflow forecast is to break up the forecast into smaller areas and then bring all the information together at the end. The five steps in preparing a cashflow forecast are:

1. Prepare a list of assumptions.
2. Prepare the anticipated income or sales for the business (called a sales forecast).
3. Prepare detail on any other estimated cash inflows.
4. Prepare detail on all estimated cash outflows.
5. Put all the gathered detail together.

Step 1: Assumptions

The assumptions used in the cashflow forecast are the same as those used for the income and expenditure budget process – refer to page 20

Step 2: Sales Forecast

For any business, sales are the key to business success. Whether you are starting a new business or have an existing enterprise, estimating sales is often one of the most difficult in the forecast process. If you think about it, your sales will be dependent on many variables, such as the types of customers you have, the terms you offer your customers, economic events such as interest rate increases or employment rates, or competitive influences. It is not possible to predict all the events that may occur and have an impact on your sales over the time frame of the forecast. This point is often the reason why many businesses do not do forecasts. However, if you accept that your forecast sales will most likely not match your actual sales, you can then focus on determining a "realistic" figure for the sales of the business over the period for which the forecast will be prepared.

For existing businesses, the best starting point will be looking at last year's sales figures. Do you believe that you will continue to achieve these figures, or have you implemented improved business operations to increase sales over the coming year? Once you have determined the likely adjustment needed to your historical sales figures, you can then estimate the forecast sales for the period.

After you have determined the sales for the period, the next step is to break these numbers up into "sales receipts" – the actual timing of receipt of the cash from sales. Remember that we talked about the timing of cash as the key to the cashflow forecasts. Again, this information will be estimated, although existing businesses will have some history to help estimate actual sales receipts.

If the business is purely a cash business (for example a fruit stall at a market), then the sales will equal the "sales receipts" number. However, as noted earlier, where credit terms are given to customers, there will be a delay in receiving the proceeds from the sale and this is where we need to estimate the timing of receipts. Applying your accounts receivable collection pattern from the past to your sales forecast is the best way to predict your cash receipts from the collection of accounts receivable. To see how this is done, we have provided an example of how to calculate the timing of cash receipts.

After reviewing his sales collection history, Joe has determined that the following sales receipt pattern had occurred in year one.

Percentage of Cash Sales	40%
Percentage of Credit Sales	60%

Applying these percentages to the estimated sales for year two, Joe completes the tables below.

Note: For Cash Flow forecasting, all estimates should include GST	**Monthly Cash Receipts**														
	Year One			**Year Two**											
	October	November	December	January	February	March	April	May	June	July	August	September	October	November	December
Total Monthly Sales	$ 4,056	$ 4,300	$ 4,800	$ 5,500	$ 5,500	$ 6,050	$ 6,600	$ 6,930	$ 7,150	$ 7,700	$ 7,920	$ 8,030	$ 8,250	$ 8,470	$ 7,700

Total Cash Sales 40%	Not Required			$ 2,200	$ 2,200	$ 2,420	$ 2,640	$ 2,772	$ 2,860	$ 3,080	$ 3,168	$ 3,212	$ 3,300	$ 3,388	$ 3,080
Total Credit Sales 60%	$ 2,434	$ 2,580	$ 2,880	$ 3,300	$ 3,300	$ 3,630	$ 3,960	$ 4,158	$ 4,290	$ 4,620	$ 4,752	$ 4,818	$ 4,950	$ 5,082	$ 4,620

The next step is for Joe to complete a table that calculates the cash collections from his credit sales. For the sales made on credit, Joe has worked out the average collection rate and has made a note in the following table:

% of sales receipts collected in month following the sale	60%
% of sales receipts collected in 2nd month following the sale	30%
% of sales receipts collected in 3rd month following the sale	10%

So, applying the above percentages to his estimated sales for year two, Joe has been able to calculate the estimated “actual” cash receipts from sales.

			Monthly Credit Sales Collected													
Credit Sales Made			**Year One**		**Year Two**											
			November	December	January	February	March	April	May	June	July	August	September	October	November	December
Year One	October	$ 2,434														
	November	$ 2,580	$ 1,460	$ 730	$ 243											
	December	$ 2,880		$ 1,548	$ 774	$ 258										
Year Two	January	$ 3,300			$ 1,728	$ 864	$ 288									
	February	$ 3,300				$ 1,980	$ 990	$ 330								
	March	$ 3,630					$ 1,980	$ 990	$ 330							
	April	$ 3,960						$ 2,178	$ 1,089	$ 363						
	May	$ 4,158							$ 2,376	$ 1,188	$ 396					
	June	$ 4,290								$ 2,495	$ 1,247	$ 416				
	July	$ 4,620									$ 2,574	$ 1,287	$ 429			
	August	$ 4,752										$ 2,772	$ 1,386	$ 462		
	September	$ 4,818											$ 2,851	$ 1,426	$ 475	
	October	$ 4,950												$ 2,891	$ 1,445	$ 482
	November	$ 5,082													$ 2,970	$ 1,485
	December	$ 4,620														$ 3,049
Total Monthly Credit Sales Collected					$ 2,745	$ 3,102	$ 3,258	$ 3,498	$ 3,795	$ 4,046	$ 4,217	$ 4,475	$ 4,666	$ 4,778	$ 4,891	$ 5,016

Now that he has his monthly cash collections from credit sales, he adds these figures to his monthly cash sales to calculate the total cash collected for each month.

Total Cash Sales 40%	Not Required	$ 2,200	$ 2,200	$ 2,420	$ 2,640	$ 2,772	$ 2,860	$ 3,080	$ 3,168	$ 3,212	$ 3,300	$ 3,388	$ 3,080
Total Monthly Cash Collected	Not Required	**$ 4,945**	**$ 5,302**	**$ 5,678**	**$ 6,138**	**$ 6,567**	**$ 6,906**	**$ 7,297**	**$ 7,643**	**$ 7,878**	**$ 8,078**	**$ 8,279**	**$ 8,096**

Step 3: Other Cash Inflows

To complete the cash inflow information in the cashflow forecast, you will need to identify any additional cash coming into the business. Of course, the types of cash inflows for each business will vary, but the following list may help you recognise other cash inflows in your business:

- GST refunds
- Additional equity contribution
- Income tax refunds
- Grants
- Loan proceeds
- Other income sources not included in sales (eg royalties, franchise & license fees)
- Proceeds from sale of assets.

Given you are preparing a cashflow forecast for additional financing, don't forget to include the loan funds in your inflows.

Step 4: Cash Outflows

As we have indicated earlier, one of the major inputs into the forecast is sales. Coupled with this inflow is the cost of purchasing or manufacturing those goods to sell. Therefore, when determining your cash outflows, it is suggested that you calculate your cost of goods sold in line with your sales forecast. By doing this, if you do need to change your sales numbers, an automatic change to the cost of goods sold figure should occur. Many computer programs will allow you set up a link between two items, such as your sales and cost of goods sold, to make the process of forecasting a little easier. In Chapter 1, the calculation of cost of goods sold was discussed, so you may like to refer back to this section or use the gross margin percentage discussed in Chapter 4 when estimating the cost of goods sold for your forecast.

Expenses

Expenses are those cash outflows relating to the operations of the business and that are not included in the cost of goods calculation. These are often referred to as “administration” or ”operational” expenditure. Again, the items of expense will depend on the type of business you are starting or currently operating. One of the important areas to focus on when forecasting expenses is the classification. Remember in Chapter 4, the difference between fixed and variable expenses was discussed. When putting together your forecast, the variable expenses will be directly related to the forecast sales numbers, so if you adjust your sales, these expenses will need to be amended in line with the sales adjustment. Of course, the fixed expenses will remain the same, although you may need to consider adjusting these for increases (e.g. for inflation).

Other cash outflows

In addition to cost of goods sold and operational expenses, you may also have other cash outflows during the operations of the business.

Examples of the types of cash outflows include:

- Purchase of assets
- One-off bank fees (i.e. establishment fees)
- Principal repayments of the loan
- Payments to the owner/s (e.g. dividends)
- Investment of surplus funds.

Step 5: Finalising the Cashflow Forecast

Now that all the relevant information has been collected, it is time to prepare the forecast. At the beginning you will have determined the time period the forecast is to cover. Remember, cashflows are all about timing and the flow of cash, so you will need to have an opening bank balance, then add in all the cash inflows and deduct the cash outflows for each period, usually by month. The number at the end of each month is referred to as the “closing” cash balance and this number becomes the opening cash balance for the next month.

An example of Joe’s cashflow forecast for year two has been provided on the following page. This cashflow forecast shows that his business is going to borrow $20,000 to purchase a car to assist in his sales and marketing by visiting his potential customers. Remember that Joe included this in his assumptions (refer to page 20).

The forecast shows that the $20,000 is borrowed in February and the car is paid for in the same month. The cash inflows include anticipated sales receipts as shown in the table on page 52. Remember, this is cash collected from sales, not actual sales made. In the cash outflows section, all the monthly expenses (inclusive of GST) as they are paid have been included and also cash outflows from expenses incurred for the loan (establishment fee etc.)

By preparing the cashflow forecast, it can be easily seen that if Joe is to borrow the $20,000 to purchase the car, he will still not have enough cash to cover all expenses for the period for which the forecast has been prepared. The main reason for this is that a percentage of sales is made on credit. This means that while sales will increase after the purchase of the car, the time lag between buying the car and increase in sales, and then the cash being collected means his business will need an additional $3,267 (maximum overdrawn amount as shown in Month five) to ensure he has enough cash to cover these timing differences. Joe will have to consider how he is going to fund this cash shortfall. Most likely, he will have to consider approaching his bank for additional funding.

In addition, there are two important points to note here. Firstly, the bank is most likely to request details of the assumptions in the forecast. Secondly, if the business were to request additional funds of only the extra $3,267, there would be no “buffer” in the event some of the anticipated cashflows changed (e.g. interest rates rose and the interest expense increased).

TIP

Once the forecast is completed, you can run some “what if” scenarios to measure how reactive your business cashflows will be to certain changes in events, such as decrease in sales or increase in fuel costs. This will show you how quickly you may run out of cash if any of these events occur.

A template for this cashflow forecast can be found on the Small Business Victoria website. The link is: http://www.business.vic.gov.au/BUSVIC/STANDARD//PC_62022.html

Month	Month one	Month two	Month three	Month four	Month five	Month six	Month seven	Month eight	Month nine	Month ten	Month eleven	Month twelve
	January	February	March	April	May	June	July	August	September	October	November	December
Cash balance at the start of each month	5,000	7,341	- 1,227	2,348	5,974	- 3,267	1,191	6,125	2,662	7,265	13,005	- 1,244
Cash in												
Sales income												
Cash Sales	2,200	2,200	2,420	2,640	2,772	2,860	3,080	3,168	3,212	3,300	3,388	3,080
Credit Sales	2,745	3,102	3,258	3,498	3,795	4,046	4,217	4,475	4,666	4,778	4,891	5,016
Loan Proceeds		20,000										
Total cash in at end of month	4,945	25,302	5,678	6,138	6,567	6,906	7,297	7,643	7,878	8,078	8,279	8,096
Cash out												
Advertising	275			275			275			275		
Bank Service Charges	17	17	17	17	20	18	20	20	18	20	18	18
GST			335			435			1,180			400
Insurance	605											
Payroll	1,625	1,625	1,625	1,625	1,625	1,625	1,625	1,625	1,625	1,625	1,625	1,625
Professional Fees								462				
Stationary	22	22	22	22	22	22	27	22	22	22	22	28
Stock Purchases		12,012			13,728			8,580			20,592	
Utilities & Telephone	60	84	104	73	55	73	115	66	84	121	73	60
Vehicle Expenses				500	358	275	302	330	347	275	198	110
Vehicle Purchase		20,000										
Other: Computer software		110										
Total cash out at end of month	2,604	33,870	2,103	2,512	15,808	2,448	2,364	11,105	3,276	2,338	22,528	2,241
Net difference (subtract Cash out from Cash in)	2,341	- 8,568	3,575	3,626	- 9,241	4,458	4,933	- 3,462	4,602	5,740	- 14,249	5,855
Cash balance at the end of each month	7,341	- 1,227	2,348	5,974	- 3,267	1,191	6,125	2,662	7,265	13,005	- 1,244	4,611

Refer to table on page 52 for sales calculations

Loan monies received for purchase of vehicle

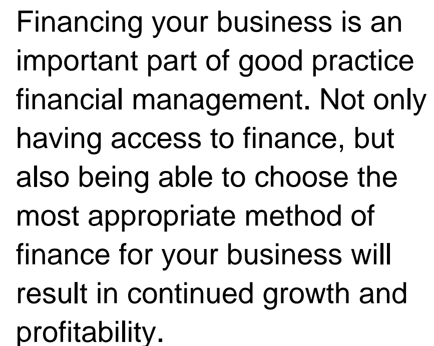
Monies paid out to purchase vehicle

Additional shortfall in funding

Financing Your Business

Just as cashflow and profit are important to the business, ensuring the business is financed appropriately is essential to achieving financial success.

Financing comes in many different forms and in this section, we will discuss funding a business with debt or equity, and the different types of loan products that can be considered. In addition, we will look at the types of transactional banking available and at specific types of finance for importers and exporters.

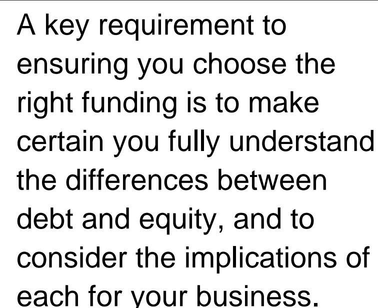


Chapter 7: Debt, Equity or Internal Funds?

Comparing debt finance, equity investment and internal funds

All businesses need finance to start up operations and in order to grow. Finance can be provided from the following sources:

- Debt – this is financing that is provided from an external source, such as bank
- Equity – this is financing that is provided from an internal source, such as an owner or investor
- Internal Funds – where profits and cash generated by the business are used to fund the ongoing operations and expansion of the business.



Many people running small business are faced with the dilemma of determining which type of funding is the right option for them. The majority of small businesses look to raise debt finance or obtain funding support from a family member in order to establish themselves. This is because it is often difficult to get an external investor interested in taking the risk of a start-up business. Debt finance or using existing funds also enables the owner to maintain control over their business rather than having to give a percentage of ownership to an investor.

Internally generated equity is the original funding provided by the owner and also may include any profits on the sale of an asset owned by the business or profits generated through business trading each year that have not been drawn out (through dividends or drawings) by the owner. It could also be any additional equity funds contributed by you as the owner.

The assets of the business can also be funded from an investor who wishes to put permanent equity capital into the business. If the business is a company, then either new shares are issued by the company or the investor may purchase some of the shares from the original owner. You should seek advice from your accountant regarding the capital gains tax and cashflow implications of each of these choices in relation to your specific circumstances.

Utilising internal funds generated from the business is, in most circumstances, one of the more favourable alternatives. Most small businesses do not adequately assess the potential ability to generate increased cashflow through good management of working capital. Chapter 5 provides details on how this can be achieved. Where excess cash can be sourced through good management of working capital, then this source of financing can provide many advantages over sourcing funding through debt or equity.

HINT

To fully understand the implications of choosing debt, equity or internal funds to fund your business, ask yourself what would happen if something went wrong.

The answer will help you make the right choice.

The table below outlines the key areas to consider when comparing debt and equity. It shows the differences between those who have an interest in the ownership of the business (equity party), such as yourself or a shareholder, and that of a party who has a debt finance relationship with your business (a bank).

The comparison looks at:

- Definitions and examples of each
- Level of risk for each financier/investor
- The type of security required
- How each funding party receives income on their funds
- Repayment of debt finance/investment capital
- Impact of the alternatives on the financial statements of the business
- Advantages and disadvantages of the alternatives.

Definitions and Examples

DEBT	EQUITY	INTERNAL FINANCE
Debt funding can be defined as: *Funds or obligations that are owed to an external party based on specific terms and conditions.* Examples of debt funding include: • Bank overdraft • Mortgage loan • Fully drawn advance • Commercial bills • Trade creditors, accounts payable • Provisions for taxation, employee entitlements • Shareholder/beneficiary loans	Equity finance can be defined as: A form of investment in the business, from the owner, partner or other people willing to take a portion of ownership of the business. Examples of equity funding include: • Issued shares/share capital (company) • Trust funds (trust) • Partnership capital (partnership) • Owner's capital (sole trader) • Retained/accumulated profits • Reserves – capital, profit/share premium/revaluation. (Note: The nature of the initial capital of an entity will vary depending on the structure, e.g. share capital is used if it is a company, trust funds if it is a trust, partnership capital for a partnership).	Internal finance can be defined as: Working capital, which is cash that is used during the operating cycle of the business. Examples of working capital include: • Cash used to buy stock • Cash required to pay suppliers Cash outstanding from customers.

Levels of Risk

DEBT	EQUITY	INTERNAL FINANCE
For a lender : **The lender takes the risk that the business may be :** • Unable to generate sufficient cashflow to service the debt • Unable to repay the principal at the end of the loan period. The lender will generally require a sufficient level of security to cover the principal. However, the costs and timing of enforcing this security poses an additional risk. **The risk for the business is generally based on:** • Changes in interest rates if exposed to variable rates • Cashflow risk as high growth requires increased working capital • Ability to generate sufficient profits to fund principal repayment • The higher the proportion of debts to equity, generally the higher the risk.	**For an Investor :** **The equity investor bears the risk** of the business and its ability to achieve the required level of growth. They also bear the risk of finding a willing buyer in order to exit the investment. The risk to the business is reduced with equity funding, as it does not impose any significant cashflow requirements on the business. It is seen as a patient form of finance. **The ultimate risk for the investor is** that they could lose their capital if the company does not survive. Therefore, their risk is both a capital and return-on-investment risk. For the owner of the business, bringing in investors usually decreases their control of the business.	**For the owner:** **The owner of the business takes the risk** that cash is used from areas of working capital that may impact on business operations. For example, to increase cashflow, the business may reduce stock levels, which could result in inadequate stock being available for sales.

What Security is Required?

DEBT	EQUITY	INTERNAL FINANCE
Lenders generally require some form of security against the funds that are lent to the business. In the event repayment conditions are not met, the lender can then call up the loan and realise the security. **The level of finance available is generally restricted or capped by the level and quality of security available.** **Examples of common security required include:** • First or further mortgages over property *(This may involve property owned by the business or personal assets of the owners or third parties.)* • Fixed charge/debenture *(Covering the total assets of the business)* • Specific asset *(e.g., stock/debtors, motor vehicle, equipment)* Some lending can be done without security, usually with a personal guarantee of the owners/directors; (however, with higher interest rates reflecting the higher risk and the lender can then call on other assets of the individual to meet business debts, subject to the terms of the guarantee).	Equity investors **do not require** any security against funds invested. The equity investor is providing risk capital based on the potential to achieve future profits and increased business value. Equity investors rank behind all other unsecured creditors when the business winds up. For this reason, they seek a high return on funds invested.	Internal sources of finance do not require any security as it is essentially using cash held by the business.

How Does Each Funding Party Receive Income on Their Funds?

DEBT	EQUITY	INTERNAL FINANCE
A lender achieves a return on their invested funds through the payment of interest. Interest terms can vary significantly, based on the terms and conditions of the finance. In order to compare the various debt products, you should be aware of: • The basis of calculation of the interest • Exposure to interest rate changes • The timing of interest payments • Fees and charges. Debt finance often has a requirement to meet both interest and principal repayments during the term of the loan. **Therefore, debt finance has an important cashflow impact on a growing business.**	An equity investor receives a return on funds invested in two ways: • Profits generated from the business (and which can be left in the business to fund future growth) • Increased value of the business. (As the business increases in overall value, the equity investor's interest in the business will increase proportionately; however, this increase in value will not be realised until the business or owner's interest is sold.) It can be seen by the above that the focus for the equity investor is on long-term growth of the business. As a result, equity funds do not generally place cashflow pressures on the business.	Using internal sources of finance will not incur any fees or interest payments.

Repayment of Debt Funds/ Investment Capital

DEBT	EQUITY	INTERNAL FINANCE
The debt finance agreement provides for the terms of repayment of the funds borrowed. The funds borrowed will be repaid either in instalments over the loan period or at the end of the period. The business will need to generate sufficient funds from profits and cashflow to meet these commitments. The lender does not share in the risk of the business or in the benefit of growth through increased value.	The equity investor has acquired an interest in the business. In order to obtain a return of the funds invested, the investor will need to sell his/her interest in the business. The return of the initial funds invested will depend on the change in value of the business and the ability to find a willing buyer or an appropriate exit strategy. The equity investor shares in both the risks of the business and in the benefits of growth. Hence, an investor may receive either more or less than what they initially invested.	No repayment of funds is required.

Impact of Financial Structure on the Financial Statements of the Business

DEBT	EQUITY	INTERNAL FINANCE
A significant reliance on debt funding provides a higher gearing structure for a business. A higher gearing reflects a higher risk as the business has more commitments to lenders than equity. A lower gearing reflects less commitment to external financiers as compared with equity funds. The use of debt can also result in reduced profits through interest expense, although debt can be more tax effective because interest payments are deducted from assessable income.	The injection of additional equity capital can provide a more balanced debt-to-equity ratio, a common measure of risk. With additional capital, the owners may be in a position to increase other debt finance, as the financial structure of the business is much stronger. Equity capital injection should allow the business to generate increased profits, as it will usually not have to service funds raised (make repayments and interest payments etc).	Utilising internal finance can provide a more balanced debt-to-equity ratio, a common measure of risk. Through the use of internal finance as an alternative finance method, the business should be able to generate increased profits, as you will not have to service funds raised.

Advantages

DEBT	EQUITY	INTERNAL FINANCE
• Retain control over the business • Growth in value of the business is retained by the owner • Debt repayment commitment can be fixed • Lower cost of capital • Lower cost of raising debt finance • Interest expense is tax deductible.	• Ability to raise funds in excess of security • No exposure to changes in interest rates • External resources could add strategic input and alliances • Improved profile with lenders • More stable financial structure • Possible mentoring support from the investor as well as their funds.	• Utilising internal finance as an alternative to debt finance will potentially increase profitability as these funds will not carry service costs • No exposure to external market economics, such as interest rates and investor appetite • Retain control over the business • All growth in the business is retained by owners • No exposure to external stakeholders such as banks or investors • No security over assets.

Disadvantages

DEBT	EQUITY	INTERNAL FINANCE
• Ability to raise funds is limited by security available • Business may be exposed to financial risks as a result of interest rate movements • Reduced opportunity to establish new external alliances with potential investors • Liquidity exposure of a highly geared structure • Business opportunities can be lost through tight cashflow • Profitability can be reduced by high debt-servicing costs.	• Loss of control and autonomy in decision-making (as other investors will want a say in the operation of the business) • Greater pressure from other investors to achieve growth and higher returns • Need to identify exit strategy • Potential personality conflict between owner and other investors • Additional costs of equity process • Greater management reporting required • Dividend payments by the business are not tax deductible • Length of time to raise equity can often be lengthy • Loss of income if dividend payments are required.	• Potential tightening of operational cash-flow if internal finance is used for long-term asset purchases • No credit history is developed • Potential loss of mentoring from investor if equity finance was an alternative • No tax deductions as no servicing costs.

Deciding between debt and equity

In uncertain economic times, you may wish to reduce the financial risk of taking on significant debt funding (it may also be difficult for you to raise debt finance), so you may need to be prepared to share the ownership of your business to increase funding to the business.

You may also consider a **combination of debt and equity funding** to meet the business requirements. An investor may be prepared to provide both equity and debt finance.

HINT

In deciding whether to seek an equity party, you need to consider both the financial and non-financial outcomes.

Considerations in selecting equity investment as your finance option may include:

- The ability to recognise an external investor's interests in operating the business
- Your attitude to losing a 100%-control position and power to make all decisions without consulting other owners
- Identification of skills of potential investors that would be advantageous to the growth of the business
- The need to reduce the risk associated with the gearing level of the business through lower interest and principal repayment commitments
- Long-term plans for succession and, if a family business, the impact on other family members
- Willingness to identify an appropriate exit strategy and its impact on you
- The opportunities equity funding will bring that could not be achieved with existing debt available to the business
- Whether your business is attractive to an investor
- Whether you have prepared the necessary financial statements and forecasts that a potential investor will want to see

TIP

Generally, a business would aim to **maximise the use of debt finance** to fund its operations, as long as the business can service the level of debt and has enough security to support the funding. The business owner would retain the benefits of ownership in respect of growth and profitability of their business.

- How quickly you need the funding.

The choice between debt and equity is, therefore, a combination of:

- Assessing the limitations that debt finance may bring
- Determining if your business has the growth potential to be attractive to an equity investor
- Evaluating your willingness and/or preparedness for the changes equity investment will require.

Many small business owners find that the retention of majority control over their business is important to them, and that their objectives are based on both lifestyle and family priorities. In these circumstances, debt will be their primary alternative for funding their business, as they are unlikely to meet an investor's objectives.

TIP

You may find the ability to raise debt improves with equity investment.

Understanding debt financing options – long term vs short term

If you select debt as a financing option, you have to consider which debt product (as there are many) will meet the needs of your business.

In making this assessment, you will need to:

- Understand the nature of alternative debt products in the market to make an informed decision
- Identify the alternative features available for each product
- Have a common basis for comparing debt products
- Match the right debt product/features with your business circumstances and requirements
- Understand the tax implications of alternative products.

HINT

It is important to review alternative finance products from different lenders and ensure you are comparing apples with apples.

In a competitive market, lenders will package finance products under different names and introduce a range of features to differentiate themselves. A list of the most common debt finance products lenders use, and an overview of each, is provided on the following page.

Evaluating Your Own Circumstances

In matching a debt product and selecting the appropriate features to suit your business requirements, you need to determine the following about your business:

- What the funds are going to be required for and how long you require them
- Whether they are for short-term funding of working capital or long-term funding, to fund a building extension or export market entry costs
- How much finance you need. (Be realistic about the amount of funds you require – don't be cut short.)
- What level of security you can offer and how the lender will view the value of the security. (Real property security, compared with business assets, is likely to result in a lower interest rate margin being charged.)
- How the lender will assess "risk" for your business.

This evaluation will help you better match your requirements and limitations to the specific "guidelines" for particular alternative debt funding.

Small Business Victoria has a "Find a Loan Calculator" that may help you determine the right debt product for your needs. The calculator can be found at: http://www.business.vic.gov.au/BUSVIC/STANDARD/1001/PC_62522.html . CPA Australia and the Australian Bankers' Association have a factsheet titled "Applying for a Loan". This can be found at http://www.bankers.asn.au/default.aspx?ArticleID=1353

Short Term Funding			
Debt Product	**Description**	**Repayment / Interest**	**Fees**
Overdraft **Purpose** Overdraft facilities are generally used to finance the day-to-day fluctuating cash needs of a business.	A facility that allows the customer to operate a bank account with a pre-agreed limit which can be drawn down. Overdraft accounts will usually only be provided to a business that has been successfully trading for a few years.	Overdraft facilities do not have a specific maturity date. The product is "at call" or on demand, which means that the bank has the right to cancel the facility at any time. Interest is usually paid on a monthly basis. The rate of interest is determined in accordance with a risk margin that the bank will determine. The customer will only pay interest on the amount of the facility drawn down.	Generally include: Application fee – one off fee to initiate the facility. Line or facility fees–generally charged on the available limit in arrears and is payable monthly or quarterly. Cheque account fees and transactional costs are also payable. Account-keeping fees – charged monthly for operating the account.
Line of Credit **Purpose** A line of credit is usually used to access funds for working capital requirements.	A line of credit or equity loan can provide access to funds by allowing the borrower to draw on an account balance up to an approved limit. As long as the balance does not exceed the approved limit, funds can be drawn at any time. These loans are usually secured by a registered mortgage over a property.	Repayments are usually required to at least cover the interest and fees on the loan. Interest is usually paid on a monthly basis. As this type of loan is usually secured against property, interest rates tend to be lower than for overdrafts. However, if you fail to make your payments, you can put your property at risk.	Generally include: Application fee – one-off fee to initiate the facility. Line or facility fees–generally charged on the available limit in arrears and payable monthly or quarterly. Cheque account fees and transactional costs are also payable. Account-keeping fees– charged monthly for operating the account.

Debt Product	Description	Repayment / Interest	Fees
Credit Card Purpose Credit cards should be used only to fund short-term working capital requirements.	Credit cards are usually offered on either "interest-free days" or "no interest-free days". They are generally easier to obtain due to the high fee structure and interest rates charged. The "interest-free" cards generally carry higher interest, charged either from the day you purchased or from statement date unless you repay in full within the interest free period. Interest on cash advances applies immediately. They also tend to carry higher fees. These work best if you pay off your balance in full each month and avoid cash advances. "No interest-free days" cards have a lower interest, which is charged from date of purchase and generally carry lower fees. This type of card will suit if you are unable to pay off your outstanding balances each month. Unfortunately, many people who don't pay their cards off each month have high interest cards and so pay more than they need to.	Credit cards usually have an expiry date, which indicates that, unless the facility is renewed, all outstanding amounts will be due by this date. Interest is generally either charged from the date of purchase of items or from the date your monthly statement is issued. For cash advances, interest is usually charged from the date of the withdrawal.	Annual account fees Fees to use rewards programs Fees for late payments Payment dishonour fees; and Fees for exceeding your credit limit.

Debt Product	Description	Repayment / Interest	Fees
Cashflow Lending Purpose This product is generally used for funding fluctuations in working capital. Best suited for service-based or distribution businesses that do not have major investments in fixed assets. In addition, many manufacturing businesses use this type of funding.	A lending facility for small businesses that generate solid cashflow, but do not own significant fixed assets to provide as security. The loan is secured by working capital assets of the business, such as stock and debtors. The cashflow projections need to reflect the ability of the business to meet finance costs. Regular reports are required by the lender. These loan facilities operate like a business line-of-credit facility, allowing you to draw down on funds as required.	The loan is similar to that of an overdraft facility in that it is approved for a specific term, with a regular review requirement. Interest is charged monthly on the daily balance outstanding.	Establishment fee–upfront fee to establish the line of credit. Service/administration fee–fixed or variable amount that is charged monthly or quarterly in arrears; based on the balance/facility limit.

Debt Product	Description	Repayment / Interest	Fees
Debtor Finance **Purpose** This product can provide core working capital finance, as well as meet short-term fluctuating needs.	The funding is secured by the value of the amount owed by the business's customers (debtors). The finance is generally available up to 80% of the book value of debtors. When the debtor is invoiced, the lender will pay the agreed percentage of the invoice. When the debtor pays the balance of the invoice, the remaining percentage is received. The benefit to the business is that they do not have to wait until the customer pays before they receive their funds. This finance effectively shortens the cash cycle for a business. The funding is very flexible as it increases with the level of sales activity and is only utilised as required. Debtor finance does not always have to be disclosed to customers, as you still handle all debt collection and interaction with the customer. This product is now a more widely accepted form of finance to manage high growth and businesses with fluctuating activity.	The debtor ledger value provides an upper limit of funds available. A business can repay part of the upper limit available. Interest is payable monthly on the funds drawn down, or alternatively, the financing company will take a percentage of the amount collected.	Establishment fee–upfront fee to establish facility Line fee–based on a percentage of the maximum facility payable monthly Administration/service fee–fixed or variable fee charged monthly or quarterly in arrears and based on the balance/facility limit.

Long Term Funding			
Debt Product	**Description**	**Repayment / Interest**	**Fees**
Fully drawn advance **Purpose** This product is suitable for financing permanent or longer term funding requirements for property, plant and equipment, or for the purchase of a business.	This product is a long-term loan that requires principal and interest repayments over the term of the loan. The term of the loan is generally between three and ten years.	A fully drawn advance/term loan is provided for a fixed period. The loan is reduced by monthly repayments, which include both interest and principal components. The interest rate can be fixed, variable or a combination of the two. There may be penalties for early repayment if the rate is fixed.	Fees include: Application fee–one-off fee to initiate the loan. Monthly account fees–fixed amount per month.
Mortgage Equity Loan **Purpose** A long-term form of finance suitable for purchase of capital assets such as land and building.	A long-term loan where residential property is used as the primary source of security. In general, lenders will lend up to 80% of their value of the residential property.	The term of the loan is fixed. Repayments will involve both principal and interest. Interest can be based on fixed or variable rates or a combination. It may also be possible to have a capped rate, which provides protection to borrowers where changing rates have reached the cap rate.	May include: Establishment fee–once-off fee to establish the loan. Administration service fees– either fixed or variable, based on the balance/facility limit or invoice amount, charged monthly or quarterly in arrears. Document fees – fees to cover mortgage registration, property valuation, legal fees and stamp duty.

Debt Product	Description	Repayment / Interest	Fees
Interest Only Loan **Purpose** Generally used for medium-term funding requirements, it is suitable where a development period is required to establish a new area of business, where cashflow is tight at the beginning.	An Interest Only Loan involves the lending of a fixed amount for a specific period, where only interest payments are required to be met during the term of the loan. The principal is due on maturity of the loan. The loan is generally secured by property or business assets.	The loans are generally for a period of 1 to 3 years. The principal is due on maturity. The loan may be rolled over into a principal and interest type product at the end of the term. Interest is generally paid on a monthly basis, based on the full amount of the loan.	Fees include: Establishment fee–upfront fee to establish the loan Administration/service fees–charged monthly or quarterly in arrears and is either fixed or variable and based on the balance/facility limit or invoice amount.
Leases and Hire Purchase Used for financing assets such as motor vehicles, plant and equipment and technology.	Leases and hire purchase finance are generally used to purchase a specific asset. The finance is often easier to obtain as the lender uses the funded asset as the main source of security. One of the advantages of these products is that they will fund the full value of the asset. Leases differ from loans (including hire purchase agreements) in that the leased item is still owned by the lender. There are two types of leases – finance and operating. At the end of a finance lease, the business has the opportunity to purchase the asset from the lender at its	Leases and hire purchase finance are generally for a period of three to five years. The repayments are usually on a monthly basis, and include components of interest and principal over the term of the product. At the end of a finance lease and hire purchase contract, there is usually a capital residual to be paid. This is known as the "balloon" payment and can be large, but is disclosed. GST is charged on repayment or hire purchases and leases.	Leases and hire purchase contracts require stamp duty on the finance arrangement. There can (at times) be a documentation fee for preparation of leasing/hire purchase arrangements. No other fees are applicable.

	residual value, whereas under an operating lease, the ownership of the asset at the end of the lease remains with the lender. Hire purchase finance is similar to a finance lease, except that ownership passes to the hirer at the outset of the transaction. Each of the above products also has different tax and GST implications		
Chattel Mortgage **Purpose** Chattel mortgages are used for financing assets such as motor vehicles and plant and equipment.	A chattel mortgage or bill of sale is a loan agreement in which you borrow funds to purchase equipment. The borrower provides security for the loan by way of a mortgage over the equipment financed. If the borrower is a company, the product will be a chattel mortgage and, if an individual, it will be a bill of sale. Under this finance, the equipment/asset will be owned by the borrower and they would expect to be able to claim the full amount of the GST as a capital acquisition on purchase of the capital item.	Chattel mortgage finance is generally over a three to five year period. The repayments are usually on a monthly basis and include components of interest and principal over the term of the product. At the end of a finance period, there is usually a capital residual to be paid.	Chattel mortgages usually require stamp duty on the finance arrangement. No other fees are applicable.

It is important to consider the impact of the above features as well as the nature of the product. In some circumstances, borrowers can structure their loan with a mix of fixed/variable/capped and other variations of interest charges. If specific features are important to you based on your circumstances, you may need to look at alternative debt providers until you find the right finance for you. You may find, however, that your circumstances limit the debt products available for your business.

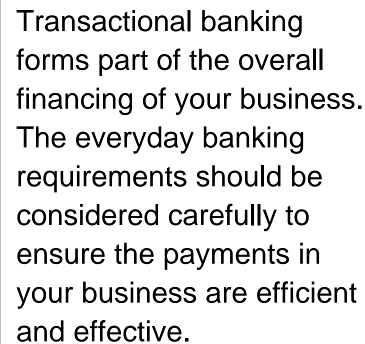
It can often be difficult for small business owners to evaluate debt product options. Lenders can have different names for similar products, and structure the terms, conditions and fees differently.

TIP

Ensure the type of financing undertaken matches the reason for seeking finance. A general rule of thumb is to match the term of the loan with the length of the life of the asset you are funding.

Chapter 8: Transactional banking to suit business needs

Transactional banking is the everyday banking requirements that your business needs to operate effectively. Primarily, this will include both deposit accounts and payment services provided by your bank or other financial institution (e.g. credit union, building society).



All businesses need to have some transactional banking services. There are essentially two types of transaction banking groups:

- Transaction banking
- Merchant Facilities

Transactional banking products

When deciding what type of transaction banking products your business will need, it is important to look at the type of business you are offering to your customers, the requirements from your suppliers and how you want to manage your cashflow. Although many businesses believe that paying by cheque offers a few extra days before the funds are withdrawn from the bank account, in reality, paying by cheque provides a level of uncertainty because you cannot be sure when the cheque will be presented.

HINT

Choosing the most appropriate transactional banking products will assist in managing cashflow and improving profitability.

With many options available to business today, it is wise to ask your bank account manager to assist in choosing the right products that will help manage cashflow and reduce the need for time spent in managing all your banking requirements.

The list below provides the most common transaction banking products currently available:

- Electronic Desktop/Internet Banking
- Credits to accounts – electronically, manually or by direct credit
- Debits to accounts – electronically, by manual cheque, EFT, or overseas transactions
- Bpay via credit card
- Bpay via debit card
- Overdraft and other limit facilities
- Cheque production or cashing facilities
- Lockbox – the processing of a mailed cheque, money order or credit card payment
- Payroll processing arrangements.

TIP

Your banker can assist you in choosing the most appropriate transactional banking products for your business.

Merchant facilities

Merchant facilities provide your customers with various options to pay by either a credit or debit card. These facilities enable you to process payments made on these cards either manually or electronically.

Some of the benefits of having merchant facilities include:

- guaranteed payment within 48 hours of the purchase being made
- improved cashflow and thus business performance
- reduced exposure to keeping cash on your premises
- reduced administration costs. You no longer have to wait for a purchase order, issue paper invoices or chase payment.
- no need for establishing accounts for one-off or infrequent transactions
- environmental protection (by reducing the use of paper).

HINT

Merchant facilities provide a real benefit to your business cashflow: your customers do not necessarily need to have cash in the bank to pay for your goods or services.

When considering merchant facilities, it is best to speak to your bank account manager to discuss the best facilities for your business. Some of the questions to consider before meeting with your bank are:

- Do you have a retail store where your customers walk in and pay for the goods with their card? You may need an EFTPOS terminal to swipe their cards.
- Do you take the majority of your orders over the mail/phone/fax/internet? Do you need an EFTPOS terminal or is there an alternative method of processing?
- Do you need a combination of the two options above? Can you have an EFTPOS terminal to swipe the cards of walk-in clients but key-enter the details of “remote” orders?
- Would a mobile ETPOS/ credit card machine assist with quicker payments?
- What volume of credit card, cash, or other payment methods do you expect?

TIP

By introducing merchant facilities, it is possible your business will benefit from quicker payment, significant reduction in invoice queries and credit control calls and, of course, improved cashflow.

Transactional fees

Unfortunately, most banks and financial institutions do not provide transactional services for free. In some instances (particularly where your margins are very small), the fees related to these services can substantially impact on the profitability of your business. With so many financial institutions providing these services, you would be wise to consider the fee structure from a number of providers before deciding on the best provider. (See the section below on how to switch banks.)

HINT

Regular review of your transactional banking services will guarantee you know how much you are paying for these services, and ensure you are using transactional services that best suit your business.

It is common knowledge that most small businesses do not know how much they are paying in bank fees. This can be attributed to the fact that they do not spend time reviewing the transactional banking arrangements and some banks may not make it easy to clearly establish the total amount of fees being charged.

TIP

By allocating all bank fees in a separate account, you will be able to clearly identify any increases in fees that could be impacting your profitability.

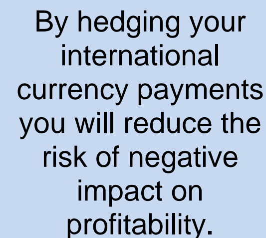
Chapter 9: Importing and Exporting Finance

Small businesses that import or export goods or services are often faced with additional challenges that come from dealing with international transactions. There are two important areas you should consider to help you manage the risk and improve cashflow when undertaking international trade:

- Foreign currency payments
- International trade finance.

Foreign currency payments

When importing or exporting goods or services, you may need to pay or receive payment in a foreign currency. Your bank can help arrange payment in foreign currency or can convert foreign currency payments into Australian dollars for you.



One of the main issues where the business is dealing in foreign currency payments is that currencies move on a daily basis and business can be subject to a fall in revenue (where foreign currency payments are being received) or increased costs (where foreign currency payments are made) and have little control over this impact.

However, there are various methods that can be used to assist business to minimise this impact. Essentially, the importer or exporter sets off the foreign currency risk by using one or more bank products – this is referred to as foreign currency hedging. Let’s have a look at these various products and how each one can be used.

Forward Foreign Currency Agreement

To minimise the impact on your profit from foreign currency movements, it may be possible to enter into a forward rate agreement with your bank. You first need to discuss with your bank to see if your business “qualifies” for the bank to offer this product.

How does this product work? The agreement between you and your bank allows you to lock in a pre-agreed exchange rate for a set date in the future. The agreed future exchange rate will be based on the current exchange rate and the financial market’s view on where the exchange rate will be at the time you settle the transaction. The benefit is that you then know exactly how many Australian dollars you will be either paying or receiving.

It important to note that once this transaction has been entered into with your bank you will be required to “settle” the transaction on the agreed date. This means you will need to ensure you either have the foreign currency to buy the Australian dollars (importer) or have received the foreign currency to sell for Australian dollars (exporter) on the settlement date of the transaction. Therefore, before entering into this type of transaction with the bank, you should make sure your international trade transaction is confirmed and payment date is accurate.

Foreign Currency Option

For some organisations, locking in the foreign currency exposure may limit their ability to provide a competitive edge. How is this so? If, for example, an importer is importing goods denominated in US dollars for delivery in three months and enters an agreement with their bank for a forward foreign currency agreement, then the importer is contractually bound to accept the US dollars he/she has purchased at the agreed rate (for Australian dollars) on the agreed date. If the Australian dollar strengthens, the importer must still honour the contract even if it is less favourable than the current exchange rate.

The importer can get around this problem by purchasing a currency option, which is like insurance.

As with insurance, an option requires payment of a premium, which can be relatively expensive. The option will protect the importer from downward movements in the value of the Australian dollar, but allow the importer to benefit from favourable movements in the Australian dollar.

TIP

Often using a combination of hedging products will provide the best protection over movements in foreign currency.

So if the Australian dollar increases in value, the importer can abandon the option. If the Australian dollar diminishes in value the importer can rely on the rate in the option. The maximum cost to the importer is the premium.

It is advisable to seek advice from your banker or CPA on which method of hedging will best suit your business needs.

Alternative methods to manage foreign currency payments

Foreign Currency Bank Accounts/Facilities

If your business has both cash inflows and outflows, you can match these currency exposures. The cashflows do not need to match precisely in terms of timing. The perfect hedge is where inflows are received at the same time as outflows are expected. However, this is rarely the case. Where the timing of the inflows and outflows doesn't match, then timing issues can be managed by depositing surplus foreign currency in a foreign currency bank account for later use, or by borrowing now to pay for foreign currency purchases, and then using the foreign currency receipts to repay the loan.

HINT

Foreign currency payments can also be managed by implementing alternative payment methods.

Negotiating to Pay/Receive in Australian Dollars

This means the supplier/customer manages the foreign exchange risk. Be careful in this situation, as the supplier may increase the cost to cover the possibility that the currency may move against them, or the customer may expect a reduced selling price to cover their risk.

Goods Paid For at the Time the Agreement is Made

This means the goods will be paid for at the foreign currency rate at the time of order; however, this also means you will have to fund the goods for a longer period of time whilst waiting for the goods to arrive, and the exchange rate may be more favourable to you at a later date.

TIP

It is advisable to speak to your banker to determine the best alternative to manage your international trade payments.

International trade finance

Letter of Credit (L/C)

A letter of credit is a guarantee by the bank that payment will be made. This is beneficial to exporters, as they are guaranteed payment from the date the L/C is entered into. This type of finance also provides protection over the export/import documentation, providing protection to the importer that the goods received will be in accordance with the terms and conditions set out in the L/C documentation.

A number of fees are attached to L/C facilities and could include:

- Establishment fees
- Documentary fees
- Presentation fees
- Dishonour fees.

HINT

Trading internationally can be a real strain on cashflow. If you can negotiate with your supplier or customer to use trade finance products, you can free up cashflow to use on other parts of the business.

Documentary Collection

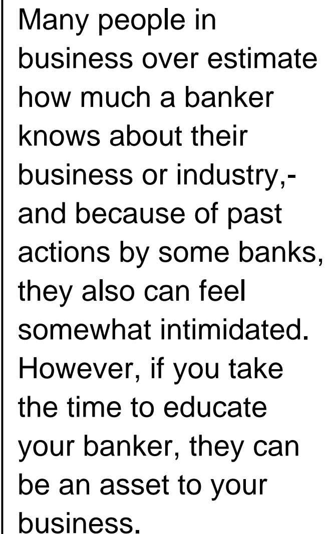
Documentary collection differs from an L/C in that there is no guarantee of payment provided by the bank. Essentially, this facility is used to minimise the risk on inaccurate documents that can impact on the delivery of goods and hence payment. Also, this facility ensures goods are shipped and payment will not be released until documents are confirmed. A deposit to secure the facility is not required and it is often a cheaper alternative to an L/C. For international trade transactions, the use of either of these facilities will be a matter of negotiation with your trade partner and bank.

TIP

For exporters, the most favourable method of payment will be prepayment, and for importers, open account (paying upon receipt of the goods).

Managing Lenders

Bankers and other lenders are generally very good at providing assistance when you are looking for finance. However, you should remember that many have not run, or been involved in, a small business. While they may have some industry knowledge, they are not business owners. So if you are seeking debt finance for your business, you need to educate a potential lender about your business and the industry you are in (in order to help them make a decision about whether to lend to you and to help you decide whether you want to receive the money from them).



If you take the time to discuss the key drivers of your business—how sales are generated and how you manage your business on a day-to-day basis—your banker or alternative lender will be far better placed to meet your needs and to act as an advocate on your behalf when you are applying for loans and other services offered.

Do shop around. You are also trying to find a lender that meets your needs. By developing a solid relationship with your lender, you will benefit from the support they will provide your business. Lenders and bankers can be great sounding boards for new business ideas, and provide insight into what is happening in your industry, as they will most likely have other customers that are servicing your industry, region etc.

Chapter 10: Applying for a Loan

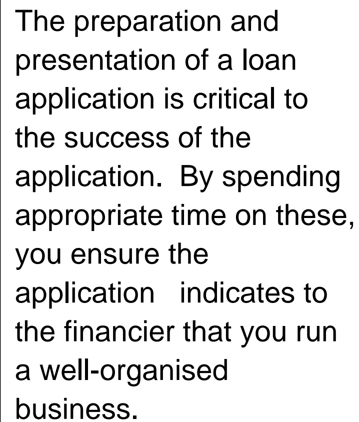
The key to a successful loan application is not only in the presentation of the information, but also in the provision of all the required information. Lenders are analytical by nature. By providing all the relevant information in your application, you ensure the lender will have something tangible to review and pass on to the credit manager and other key decision makers. In most cases, the loan officer processes the application and makes recommendations to the credit manager and/or loan committee. By providing the relevant information to your loan officer, you make sure he or she will have everything that is required to present and support his or her recommendation for your loan application.

HINT

If you follow the guidelines as detailed in this section, you will be well prepared, better informed and hence more confident in your approach to potential financiers.

Preparing a loan application

The objective of preparing the loan application is to show the financier that providing you with a business loan is a worthwhile proposition. One of the most important aspects of your loan application is to demonstrate to the lender that you can organise your thoughts and ideas in writing and can support them with financial information. If you have used an adviser or accountant to prepare your financial information, make sure you understand them before meeting with the lender.



To increase your chances of success, your loan application package should be easy to review. An example of how to collate your information is detailed below.

Sample Loan Application

1. Summary of application information (often called an Executive Summary)
2. Short written information on:
   a. Company History
   b. Industry information
   c. Ownership details.
3. Details of the loan required
4. Forecast financial information
5. Forecast assumptions including any independent information to support assumptions and any alternative plans that can be implemented if events do not go according to plan. (Refer to Chapter 3)
6. Details of any sensitivity outcomes and/or comments on financial ratio analysis of forecasts and budgets. (Refer to Chapter 2)
7. Personal information
8. Historical financial information
9. Financiers loan application forms
10. Other information – review financiers checklist
    Can include certificates of insurances, work cover obligations, any union representation etc.

Details of the loan required

The potential lender will need to review why you are applying for a loan. You will have identified the amount of the loan when preparing your cashflow forecasts and now you need to provide a detailed description of the loan required. The application should contain all the information on the funding required and should include the following information:

- Purpose of the loan
- Amount of the loan required
- Duration of time the loan will be required
- How the loan will be serviced
- What security is available to support the loan.

Each of these points is discussed in more detail in the material below..

The Purpose of the Loan

A detailed description of why the loan is required should be included in the application. Although this sounds like an obvious inclusion, the purpose is very important to a potential lender. Most lenders will not be willing to provide a loan to assist in funding operating losses or the purchase of luxury assets for the business owner. The purpose should be set out simply and clearly. This may include:

- Funding capital expenditure such as plant, equipment, vehicles, property and improvements
- Increased working capital resulting from growth or to support increased stock holding
- Replacement of existing equity with debt
- Succession planning to provide an exit strategy for family members
- Acquisition of another business or part of business
- Research and development or commercialisation stage
- Expanding distribution or developing new markets.

Example of Statement of Purpose

As a result of a new sales agreement with XYZ, our business will require an increase in stock purchases to fulfil the contract requirements. The funding will support this business growth through the purchase of additional stock. This contract will increase annual revenue by a minimum of 20%.

If the loan is to be used to purchase an asset (i.e. equipment or property), or for a contracted service, then provide the lender with all the important documentation that you have collected relating to the purchase. The important documents should include any agreement or contract to be signed, quotations for the asset or service, any specific requirements for the installation of the asset or provision of the service etc.

It is imperative to link the purpose of the loan to the overall business benefits that will be achieved as a result of the additional funding. It is also important at this point to state when the funds will be required. We often underestimate how long it will take the bank or lender to process the loan application and this can have an adverse effect on the business if the funds are not available when required. Make sure you submit your application with plenty of time for the assessment to take place.

The Amount of the Loan

The amount of funds required will be determined from your planning. Whether you are starting up a business, or funding an existing business, the planning stage will be the same. In a start-up scenario, the planning will be undertaken as part of the initial business planning process. For an existing business, a new business plan should also be undertaken. It is good financial practice to revisit your business plan when key elements of your business change.

In order to determine the total amount of funds required, you will need to prepare a cashflow forecast. This forecast must be prepared as if the loan has been successful. This forecast should cover the expected duration of the loan. All of these details were covered in Chapter 6.

It is important to remember there will be a number of costs you will have to pay when the lender provides the loan. Some of these costs will have to be paid at the time the loan is made available; other costs will be incurred over the period of the loan. Make sure these costs are included in your cashflow forecast to ensure you will have adequate funds to cover all costs.

Upfront costs can include:

- Establishment fee
- Guarantee fee
- Legal fees
- Valuation fees

Ongoing fees can include:

- Half-yearly loan charges
- Interest (can be charged monthly, semi-annually, annually)
- Transaction fees (charged every time the loan funds are accessed)
- Default fees.

When determining the amount of funds you would like to apply for, in addition to including the costs associated with the loan funds, you should consider including a ”buffer” amount. This is an amount above what your plan shows as the minimum amount required to finance your activities. Generally speaking, it is not possible to

forecast all events. A buffer will allow for any unexpected expenses or lower than expected income that is earned over the period of the loan. You will need to make an assessment of an adequate 'buffer' amount. Discuss this with the lender, as they may be able to assist in determining the level of contingency required.

Term of the Loan

Through your planning, it will become obvious how long you will need the funds for. A cashflow forecast shows the movement of cash in and out of the business, and indicates when the business will be in a position to repay the funds. Another important factor in determining the term of the loan is the type of loan that you may be seeking. Some types of debt finance have a maximum term available. For example, where funds are required to purchase an asset, a lease may be the most appropriate debt product and the lease company may only provide lease funds over a maximum of five years. So again, the cashflow forecast will assist in determining what types of finance products you are able to consider.

Servicing the Loan

The most important element of the funding application is to show the lender that the business has sufficient Cashflow to make the regular loan repayments, including all the associated costs of the loan, over the life of the loan, and ultimately repay the loan. This will entail having a good understanding of your financial statements, most importantly the cashflow forecast.

You must be in a position to make a strong case to the lender on how the forecast cashflow will adequately support the repayment obligations of the loan within the allocated time frame. Reviewing the financial ratios on your forecasted profit and loss and balance sheets will also provide information on the expected profitability and financial health of your future business operations.

Security for the Loan

For most types of loans, lenders will require security (also known as "collateral") over the loan. As part of your preparation, make sure you identify what security you are prepared to offer a lender. Appropriate security provides the lender with some comfort that in the event the business is not able to repay the loan funds borrowed, they can liquidate the security items to repay the outstanding funds.

For a successful loan application, it is important that the security offered matches both the type of loan being made and the lender's perception of the risk associated with the loan application. For example, where the loan is for a medium term of three years, then stock or customer receivables will not be acceptable as they are short-term assets. The lender will be looking for security that has value that exceeds the duration of the loan. So, more appropriate security would be equipment or property that has a valuation in excess of the loan over a lifespan of more than three years.

It is recommended that you identify and provide details to the lender of the security available, as part of your loan application. This way, you will be able to present your preferred security prior to the lender nominating his or her preferred security.

Forecast Financial Information

A lender will pay particular attention to the budgets and forecasts, as these will show how your business will operate during the period of the loan. It is therefore important to know

how to prepare these forecasts in line with your lender's expectations. By preparing both a cashflow forecast and profit and loss budget, you will have sufficient information to prepare a balance sheet budget. Remember, a balance sheet is financial information "at a point in time"; therefore, it has less importance to a potential lender when they are reviewing forecasts. This is because they are using the forecast information as a guide to "the continuing" operations of the business, rather than "at a point in time."

Cashflow forecast

A cashflow forecast is probably the most important information for the lender. It will provide the necessary detail to a potential financier on the cash available to pay back the loan. (Refer to Chapter 6 for information on how to prepare a cashflow forecast.)

Profit and loss budget

A profit and loss budget will indicate to the potential lender whether the new business plan is profitable. (Refer to Chapter 3 for how to prepare a profit and loss budget.)

Personal Information

Although lenders are in the business of lending funds to business, they like to make sure that the funds will be repaid. One of the most important indicators for them will be your own personal spending habits, which will show them how you manage your own finances, and will be particularly important when the business loan application is for a business start-up, where a history of the business patterns has not yet been established.

When you are applying for loan funds, it is most likely the lender will undertake a personal credit check; the authorisation to do so is usually included on your application form. A clear report will mean you have not, in the past, defaulted on any payment obligations and this will impact positively on your business application. Therefore, maintaining a good personal credit rating will help. Paying your credit cards and personal loans on time will be considered favourably by a lender, as it helps prove you are able to meet the debt obligations when they are due and payable.

The types of personal information the lender will be looking for can include:

- Personal assets—purchase price and date, independent valuation if available, ownership documents (i.e. mortgage or leasing agreements) and, for any policies, the most recent policy statements
- Tax returns—You may be required to supply supporting documentation to the tax schedules such as proof of income e from investments etc
- Personal bank details—all statements issued from the bank or financial institution. For bank loans, include the original loan agreement as well as the statements.

To gain an understanding of your personal position, the lender will usually require the key information from the past three years. This is to ensure any unusual circumstances are "averaged" over the period. The checklists below can be used to prepare all the relevant personal information required for the loan application.

Income Details	
Type of Income:	Gross Monthly Amount
Taxable:	$
Non-taxable:	$
Full value of rental income:	$

Financial Position				
	Value	**Balance/ Limit**	**Monthly Payment**	**Financier**
Assets and Liabilities				
House				
Investment Property/s				
Vehicle/s				
Household Contents				
Investments				
Savings				
Personal Loan/s				
Credit Card/s				
Store Card/s				
Superannuation (present value)				
Other				
Total				

Net Worth*	

*(Calculated as the total value of assets less the total of the balance/limit column)

Historical Business Information

For existing businesses, the lender will want to review historical financial information. Typically, where it is available, they will want at least three years' business records to give an indication of the business operations. The financial information they require will be the statements outlined in Chapter 1—balance sheet, profit and loss statement and cashflow statements. Ideally, this information should be either prepared and or reviewed by an accountant. This will give comfort to the lender that all the information contained in the statements is accurate, complete and correct.

In addition to the financial statements, the lender will most likely also want to check the historical operating data of the business. This will provide an overview of the way the business is managed and some insight into the character of the owner/s. Such information may include (but is not limited to):

- Previous BAS statements (usually for the last four returns)
- Annual tax returns, including the assessment notices received from the ATO
- Current accounts receivable and payable schedules (debtors and creditors lists)
- Bank statements for all bank accounts and loans for the past three years
- Details of any current or previous bank or other loans including all loan agreements and statements
- Details of any other types of financings such as leasing or hire purchase
- Previous bank relationships
- Key customer relationships.

You may like to use the following checklist to help prepare the historical information.

This information checklist can also be used when preparing for the annual review by your current lender.

TIP

The more information you present to the financier about your industry, the company, key management, and your marketing plan, the easier their job becomes to review and support the loan application. Loan officers agree that a complete, well-prepared loan application will go to the top of the pile.

Presentation of the loan application

The most important assets of a small business are the experience of the owners, the potential value of prospective customers and other non-financial items. It is for this reason that the meeting with the lender will be as important as the package presented. The lender will be looking at your confidence, management style and capacity to understand financial and other risks associated with your business. It is extremely important that you meet personally with the lender. In doing so, you will be able to present yourself, your business and your financial needs in a manner that will convey a message of confidence and capability to the lender. This may well be the first step in developing an ongoing relationship that will foster the growth of your business in the future.

HINT

Make sure you understand all the financial information that has been prepared and is being presented.

To ensure your meeting is successful, establish the expectations of the lender before you meet with him or her. This can be done by looking at the website of the financial institution or by contacting the institution and asking for a checklist of the information that will be required.

In addition to the loan application package, be prepared to discuss certain aspects of your business, competitors and industry. Be prepared for the lender to look at relevant financial ratios. Make sure these ratios on your forecasts are within the acceptable levels and that you understand what the ratios mean. Furthermore, a good presentation will include discussion on the sensitivity of the ability to repay the loan. This means you know where the risks in the forecast may be, and have thought about potential fallback plans in the event the activities don't go according to the plan.

Be confident when you present your loan application. Dress for success. If you have forgotten something, don't get flustered. Explain to the lender that you have forgotten the item and that you will deliver it later that day or the following day. The same goes for any additional information that the lender may request that you have not included in your application.

TIP

When applying for a loan, always meet your banker in person to discuss the application.

The role of advisers

Accountants and business advisers can assist in preparing a loan application. They will be well versed in translating your future ideas into financial forecasts. They will also be able to assist you in your meeting preparation, as they will be able to emphasise the potential areas the lender will focus on. You may even want to practise your presentation with them. However, it is important to remember that the financier will be looking at your ability to manage the future growth of your business, so you must ensure you fully understand the information you present.

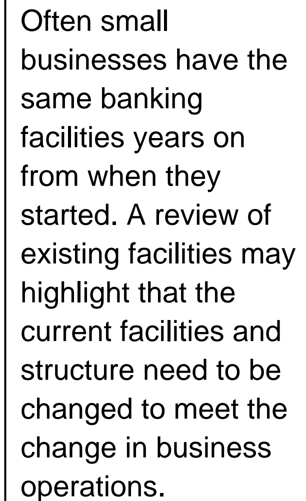
The finale

If your loan application is denied, find out as much as you can about why it was not successful. This will assist you in any future loan applications you may consider.

Above all, remember that the lender is in the business of providing loans, and therefore will be looking for future business. Often loan applications will fail not because the business is too high a risk, but more likely because the loan application was poorly prepared, indicating a lack of dedication and/or understanding, which sends immediate warning signals to the lender.

For more information on applying for a loan for your business, visit the respective web sites of potential lenders and download a CPA Australia/Australian Bankers' Association factsheet on applying for a loan at
http://www.bankers.asn.au/default.aspx?ArticleID=1353

Chapter 11: Refinancing Your Debt

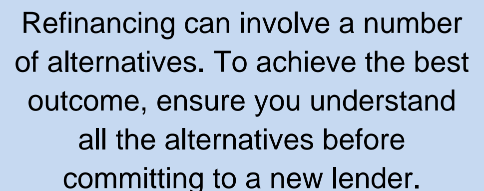


For many small businesses, the initial financing arrangements put in place at start-up are still in place many years later. For example, a business starts off with a simple overdraft facility and just arranges for several modest increases in the facility without considering the cost–benefit of the facility or the suitability of the debt arrangements to its needs.

Small business owners are encouraged to review existing debt finance arrangements on a regular basis to ensure the finance facility and structure fit the current needs of the business. You may find there is a strong business case for refinancing the business. This process should not be undertaken lightly, as there are many pitfalls in changing lenders, all of which should be considered as part of your review.

Refinancing your debt finance may involve:

- Changing lending institutions (but retaining the same debt products)
- Funding the business from different debt products (with the same or a different lender)
- Combining debt into a single facility or product
- Increasing or decreasing the total amount of the borrowing as part of the refinancing
- Changing the repayment amount or timing
- Increasing or decreasing the security offered to the lender/s.



How refinancing works

Refinancing involves taking out a new debt facility where the new funds are used to pay out your old debt facility. This is all done by the new lender. If the refinancing involves an increase in debt, then additional funds would be available to draw on.

The key reasons why you choose to refinance may include:

- Gaining a better interest rate from a different lender or from a different mix of debt products
- Switching to fixed rates or back to variable rates
- Gaining more flexible features in a facility to meet your business needs
- Increasing your overall borrowing with a new debt facility
- Changing the financial cashflow commitment required to fund debt (e.g. fully drawn advance to an overdraft)
- Consolidating debts to minimise and simplify repayments
- Releasing security over personal/specific assets as the business reaches a level of continued profitability

TIP

Make a list of the reasons why you might consider refinancing your loan to compare against the loan offer you receive.

HINT

After carefully undertaking a cost–benefit evaluation of refinancing, you may find it brings a range of new opportunities to your business.

Benefits of refinancing

Many benefits may be gained from refinancing. Some of these are outlined below.

A new perspective based on your current position and not the past

You may find that a "fresh start" with a new lender may not carry any of the long-term pre-conceptions which your previous lender may be influenced by. These may have included a poor trading period in earlier years or a particular experience they have had with another customer in your industry, which has influenced their lending decision-making against your interests.

Access to increase in debt finance

Refinancing may also result in increasing the finance available for business growth. You should ensure that, in taking on additional debt, you can still service the higher debt commitment and that these funds are utilised to achieve a higher return for the business.

Consolidation of debt funding – cashflow savings

There is often an opportunity to combine a number of ad-hoc debt finance arrangements into a single product to simplify repayments and to potentially reduce your monthly cashflow repayment commitment.

Restructuring security offering

Refinancing may also provide the opportunity for a change in the security being offered to the new lender. You may find that, over time, the value of security offered to the existing lender has increased at a far greater rate than the level of borrowing. When you negotiate your refinancing, review what is a reasonable offer of security assets.

TIP

Refinancing a strong healthy business may also mean there is an opportunity to separate your personal assets from security offered if the value of the business assets (i.e. commercial land and building, debtors, fixed assets etc) is sufficient to cover the borrowing.

For more information on refinancing, please see the CPA Australia/Australian Bankers' Association factsheet titled "Refinance your Business Debt'" at http://www.bankers.asn.au/refinancedebt .

HINT

Ensure you have undertaken sufficient review of your circumstances prior to making any commitments for refinancing, as there are many pitfalls that may impact any perceived benefit.

Common dangers in refinancing

When considering refinancing, make certain you understand all the implications before changing your facilities.

What is the cost of paying out your existing debt facility?

Your existing facility may have an "early repayment penalty" clause, which could outweigh any future interest savings. Other exit fees may include discharge of mortgage costs if property is involved as security. Deferred establishment fees may apply.

What will be the ingoing costs of the new finance facility?

Changing to a new lender (as opposed to a new product with the same lender) will require additional costs such as application, documentation, valuation (to value your security assets), mortgage fees, stamp duty on a new mortgage and settlement fees. If your new lender is keen to get your business, you may be able to negotiate a waiver of some of the bank's internal costs as part of the package.

Impact of security assets used to support multiple borrowings

When you are refinancing, you need to be aware of how your existing financing is linked to your security assets. For example, your existing bank may provide an overdraft facility, using security over your residential property, as well as an eftpos/credit card facility and access to an automated payroll system to transfer funds into employee bank accounts. If you change your debt facilities to a lender that does not have retail facilities such as eftpos and credit card processing, you may find you need additional security to guarantee these facilities.

Change in valuation of your security

Before you commit to a change of lender or product you need to ensure you have a firm letter of offer in place and not one that is subject to satisfactory valuation or a third-party validation (such as a mortgage insurer) on the security required. Different lenders can come back with lower or higher valuations of your property, depending on the value used or the current market conditions.

Impact of leaving a long-term banking relationship

You need to assess the strength of your long-term relationship with your current lender. Are there some intangible benefits that you have now, because the current lender knows your banking and business history, which you may not be afforded in a new relationship?

How to switch banks

A good banking relationship is crucial to your business operation and, in many cases, the financial survival of your business. Banks are vital to the financing of your business operation and a good relationship with your bank can help you negotiate better terms for your banking needs. Even if you are satisfied with the service quality of your bank, you should still meet with your bank at least once a year to discuss your banking requirements and areas of improvements in products and services that your business could use.

If you are not happy with the service of your bank, you should review your bank accounts and facilities. What you should not do is move to another bank without comparing the services provided by your current bank(s) with those of the new provider.

HINT

Use the Small Business Victoria Loan Finder at: http://www.business.vic.gov.au/scripts/nc.dll?BUSVIC:STANDARD:1001:pc=PC_62522.html to help assess what each bank can offer.

Many businesses split their banking between two or more financial institutions to have more control over their financial arrangements. These businesses usually have one main bank provider who does most of their banking transactions. If you are dissatisfied with the pricing or service levels of your main provider, you should compare its offer with those of other banks.

TIP

Make a list of all these points and note the pros and cons for each point to help assess whether to refinance.

Banking Review

You can use the following checklist to help you review your bank accounts and facilities:

1. Create a list of all bank accounts in your company	You should include what the account is used for; bank account details such as branch, BSB, account number, account name; and any special arrangements with each account such as set-off arrangements. All social accounts, old companies, branch accounts, petty cash accounts and special-purpose accounts should be included. This information can be obtained from your bank statements or by asking your bank(s). You may be surprised at the number of accounts you have.

2. Obtain a letter of facilities	Request a letter of facilities from all the banks you deal with. The aim is to build a complete picture of all your banking arrangements with your financial institutions. In your letter, you should ask your banks to ensure all facilities are covered, including: • Credit or purchasing cards • Merchant facilities • Trade facilities • Lease facilities • Any information on loans that the bank provides • Letter of credit • Internet banking • BPay • Cheque cashing.
3. Select your top three preferred banks	How you select your top three preferred banks can be based on any criteria, such as the bank you have the most transactions with, the quality of their service, friendly staff, convenience, or pricing sensitivity. Knowing the existing or likely account manager (and having a favourable impression) is often a good reason to include a bank in your list.
4. Meet with your current bank	Once you have collected the required information, you are ready to meet your bank. The aim here is to give your existing bank first chance of improving the price and/or service or any other criteria you have noted in step 2. When the bank has all your information, ask your banker what will be the best package and fees available to you. Usually, a bank will give you its best rates when you agree to do all transactional banking arrangements through them.
5. Review your current bank's offer	The areas you should be reviewing are loan fees, interest margins, merchant facilities, and cash handling, if you are in a retail business or organisation. However, this will vary according to your business. If your current bank offers you improved pricing and service levels, you may wish to stay with your current bank and stop the review process. We recommend you then ask your bank to detail a letter of agreement including the renegotiated fees, charges and service levels offered. If possible, negotiate for these revised terms to apply for one to three years. If your bank does not offer a better deal in pricing, you should find out why and what is missing from the picture.
6. Meet with alternative banks on your list	If you are not happy with your current bank's offer, make an appointment with the next bank on your preferred bank list. If you disclose your current pricing, the second bank may only offer you a deal that is slightly better than that of your current bank. Due to the cost and resources required to move to a new bank, it is generally not advisable to move banks unless the new bank offers substantially better pricing, product or service.

You should consider the following factors before you change banks:

- Will your business incur additional costs as a result of switching banks? (For example, costs in notifying customers and suppliers, changing deposit and chequebooks.)
- Is the new bank's service level good? You may be able to find out by talking to some of their customers. You may have customers or suppliers who have an account with the new bank.
- Give preference to the bank that allows you to meet with bank staff other than your account manager. This should include the bank manager and perhaps even the regional manager. Often, staff change on a regular basis within banks, so it is preferable that more than one staff member of the chosen bank has an understanding of your business and the banking relationship.

TIP

Comparative information on bank finance is available on the CPA Australia website at: https://www.cpaaustralia.com.au/cps/rde/xchg/cpa-site/hs.xsl/knowledge-leadership-toolkit-guides-small-business-indicators.html

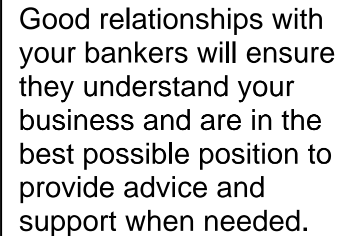
Chapter 12: Managing your Banking Relationships

Annual review

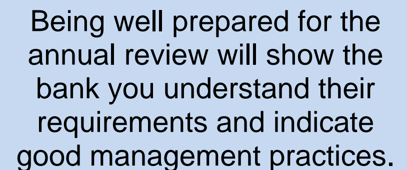
When you arrange a business loan or other finance through a bank for the first time, you may believe that the process of providing information and being interviewed by the bank is over. This is not so. When they have provided finance, banks may also carry out an annual review. This usually happens either when your annual accounts are available or on the anniversary of the borrowing.

Annual reviews should be taken seriously because banks always have far-reaching power to cancel a loan they have granted. The review results in a submission to the bank's administration, with the manager recommending continuance or withdrawal of the loan. Although a review of this kind may appear traumatic, there is nothing to worry about if your business is performing well, and it may result in an offer of further finance. If the business has been successful, the bank may also be willing to reduce its costs, but most likely only if you ask.

If your business has not been performing well, and you have not previously advised the bank, you should be candid about the position.

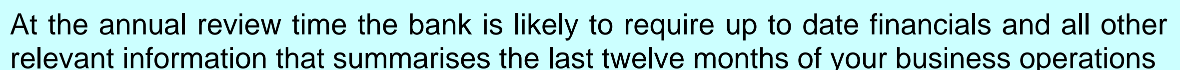


Good relationships with your bankers will ensure they understand your business and are in the best possible position to provide advice and support when needed.



HINT

Being well prepared for the annual review will show the bank you understand their requirements and indicate good management practices.



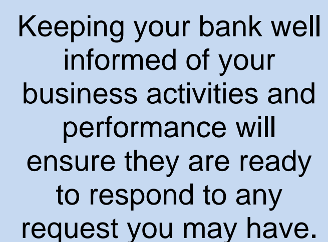
TIP

At the annual review time the bank is likely to require up to date financials and all other relevant information that summarises the last twelve months of your business operations

Continuing relationship

Banking is essentially a hands-on type of activity. A good bank manager keeps a watchful eye over the businesses under his or her control, both evaluating the risks involved and looking for new business opportunities.

There are advantages in this for a business that is well run. As well as maintaining an overview that is designed to protect the bank, the bank manager is also a salesman with sales targets. A business that is clearly performing well can therefore expect to be able to obtain increased bank assistance to match any growth in requirements.



HINT

Keeping your bank well informed of your business activities and performance will ensure they are ready to respond to any request you may have.

For the relationship with the bank to develop well, there is one requirement that must be observed: there must be a candid approach that involves keeping the bank properly informed. Any tendency to tell the good side and leave the bad side unmentioned should be avoided. Any downward turn in events should be discussed with the bank manager as soon as it is known, not when the overdraft limit is exceeded or loan repayments are late. Remember, while the bank is providing facilities, they are effectively in partnership with your business.

One of the advantages of a well-developed banking relationship is that the experienced bank manager can assume some of the role of an unpaid financial adviser. Bank managers have experience with many types of businesses and, since they are not closely involved, can give impartial advice.

TIP

Bank managers are often working with other businesses in similar industries and can be a source of useful information for your business.

If difficulties arise

Bank loans usually have conditions of default, with the bank being able to demand payment if one or more conditions are breached. Also, overdrafts are at call, with the bank being able to ask for repayment on demand.

Before a bank decides to call in a loan, there will normally have been discussion and/or a letter expressing its concerns. If the bank decides not to allow continuing default or escalation in borrowings, it must provide written advice that banking facilities have been withdrawn, in which case it will ask that all monies be repaid immediately.

HINT

If your business is having problems, such as difficulty keeping up repayments, discuss them with the bank immediately so they can work with you to find a solution.

It is in your best interest to contact the bank immediately if your business is facing difficulties, as there may be several ways the bank can help you. They may:

- Agree to change your borrowing arrangements to make repayment easier
- Discuss with you, and if you wish, your accountant or advisers, your plans for improving cashflow and profits
- Recommend you discuss your problem with your CPA or put you in touch with independent advisers, who can help you and possibly assist with your business problems.

TIP

Bank managers are more ready to provide any required assistance, such as a renegotiation of repayments, if they are told about a deteriorating position rather than having to find out about it themselves.

Better Business Financial Management

Financial management is not only about understanding the financial information in your business and using this information to improve business operations, but also about ensuring you have the right policies and procedures in place to make sure the financial information you are using is accurate and that you can protect your investment in the business. For complete financial management of your business, you need to consider implementing good financial controls.

When you are using financial information to make decisions, it is important that policies and procedures are in place to ensure the information is complete and accurate and will lead to the correct decisions.

Chapter 13: Financial Controls

A financial control is a procedure implemented to detect and/or prevent errors, theft or fraud, or policy non-compliance in a financial transaction process.

Financial control procedures can be implemented by either an individual or as part of an automated process within a financial system.

Each financial control procedure is designed to fulfil at least one of the following eight criteria:

Financial controls are policies and procedures used in your business to protect your assets and to support good financial reporting.

Completeness	All records and transactions are included in the reports of the business.
Accuracy	The right amounts are recorded in the correct accounts.
Authorisation	Approved authorisation levels are in place to cover such things as approval, payments, data entry and computer access.
Validity	The invoice is for work performed or products received and the business has incurred the liability properly.
Existence	All assets and liabilities recorded in the books actually exist. Has a purchase been recorded for goods or services that have not yet been received? Is there correct documentation to support the item?
Handling errors	Procedures ensure that errors in the system have been identified and corrected.
Segregation of duties	Certain functions are separated. For example, the person taking cash receipts does not also do the banking.
Presentation and disclosure	There is timely preparation of reports for compliance and/or review.

Benefits of financial controls

HINT

If you are using inaccurate financial information for decision-making, you could be making the wrong decisions.

Financial control procedures ensure that all financial information is recorded and accurate.

Some of the benefits of implementing financial controls are:

- Regular reporting will provide accurate financial information that can be used by those responsible for the operations of the business. (For example, sales numbers can be provided to sales representatives to monitor targets and budgets.)
- Business can make informed decisions on budgets and spending.
- Controls provide documentary proof for compliance requirements (e.g. GST calculations).
- Business standards are set and every person within the business is informed of these standards through reporting.

Good financial control procedures will:

Align objectives of the business	Ensure reporting procedures and the activities carried out by the business are in line with the business's objectives
Safeguard assets	Ensure the business's physical and monetary assets are protected from fraud, theft and errors
Prevent and detect fraud and error	Ensure the systems quickly identify errors and fraud if and when they occur
Encourage good management	Allow the manager to receive timely and relevant information on performance against targets, as well as key figures that can indicate variances from target
Act against undesirable performance	Authorise a formal method of dealing with fraud, dishonesty or incompetence when detected
Reduce exposure to risks	Minimise the chance of unexpected events
Ensure proper financial reporting	Maintain accurate and complete reports, and minimise time lost correcting errors and ensuring resources are correctly and efficiently allocated.

TIP

Good financial controls will protect your investment in your business and ensure the business runs more efficiently, resources aren't lost and there are fewer unpleasant surprises.

Financial Controls Checklist

HINT

Using the checklists will help you determine which financial controls are relevant for your business, and highlight the areas where you can improve your financial controls.

To manage the risk of a financial transaction processing failure, manual and/or automated control procedures should be implemented at key stages of the process.

Some of the questions that can be asked are:

- How well are the financial aspects of the business managed?
- Are the business operations protecting the organisation against disasters, internal theft and unfavourable external audits?
- How comprehensive are management practices?
- Are the financial records truly accurate?

This checklist will help you review your business's financial controls. A business with good financial management practices would answer "yes" to most of the following questions:

General	YES/NO
Is a chart of accounts used?	
Is it detailed enough to give adequate management information?	
Is a double-entry bookkeeping system used?	
Are journal entries used?	
Are journal entries approved?	
Do you use budgets and cash projections which are: • compared to actual results?	
• investigated if there are major discrepancies?	
Do you understand the form and contents of the financial statements?	
Are comparative financial statements produced and reviewed?	
Are the books and records kept up to date and balanced?	
Is financial information produced regularly?	
Are reasonable due dates imposed for preparation of financial information?	
Are storage facilities safe from fire etc.?	
Is insurance coverage regularly reviewed?	
Is there a records-retention schedule used?	

Sales	YES/NO
Is there a policy for credit approval for customers?	
Are credit files kept current?	
Are credit checks on customers done regularly?	
Are sales orders approved for price, terms, credit and account balance?	
Are all sales orders recorded on pre-numbered forms and are all numbers accounted for?	
Do you review the monthly debtors' statements for outstanding balances?	
Is accounts receivable subsidiary ledger balanced monthly to control account?	
Is an aging schedule of customers' accounts prepared monthly?	
Are write-offs and other adjustments to customer accounts approved?	

Cash Receipts	YES/NO
Do you, or a responsible employee other than the bookkeeper or person who maintains accounts receivable: • Open the mail and pre-list all cash receipts before turning them over to the bookkeeper?	
• Stamp all cheques with restrictive endorsement "for deposit only" before turning them over to the bookkeeper?	
• Compare daily pre-listing of cash receipts with the cash receipts journal and the duplicate deposit slip?	
Are cash receipts deposited intact on a daily basis?	
Are cash receipts posted promptly to appropriate journals?	
Are cash sales controlled by cash registers or pre-numbered cash receipts forms?	

Cash Used (disbursements)	YES/NO
Are all disbursements, except for petty cash, made by cheque or internet payments?	
Are cheques pre-numbered and all numbers accounted for?	
Are all cheques recorded when issued?	
Are all unused cheques safeguarded, with access limited?	
Is a mechanical cheque protector used to inscribe amounts as a precaution against alteration?	
Are voided cheques retained and destroyed?	
Do you sign or view all cheques and internet payments?	
If a signature plate is used, do you have sole control?	
Are supporting documents, processed invoices, receiving reports and purchase orders presented with the cheques and reviewed by you before you sign the cheques?	

Are supporting documents for payments properly cancelled to avoid duplicate payment?	
Are cheques payable to cash prohibited?	
Are signed cheques mailed by someone other than the person who writes the cheques?	
Are bank statements and cancelled cheques: • Received directly by you? • Reviewed by you before they are given to the bookkeeper?	

Bank reconciliation statements	YES/NO
Are bank reconciliations prepared: • At least monthly for all accounts? • By someone other than the person authorised to sign cheques or use a signature plate?	
Are bank reconciliations reviewed and adjustments of the cash accounts approved by a responsible person other than the bookkeeper?	

Petty cash	YES/NO
Are all disbursements from petty cash funds supported by approved vouchers?	
Is there a predetermined maximum dollar limit on the amounts of individual petty cash disbursements?	
Are petty cash funds on an imprest basis (i.e. the total amount is set e.g. $100, you can only spend what you have and it's only topped up by the amount spent)?	
Are petty cash funds: • Kept in a safe place? • Reasonable in amount so that the fund ordinarily requires reimbursement at least monthly? • Controlled by one person? Periodically counted by someone other than the custodian?	

Accounts Payable	YES/NO
Are supplier invoices matched with applicable purchase orders and receiving reports?	
Are all available discounts taken?	
Is there written evidence that invoices have been properly processed before payment, e.g. stamped?	
Are there procedures that ensure any direct shipments to customers are properly billed to them?	
Do you verify that the trial balance of accounts payable agrees with the general ledger control account?	
Are expense reimbursement requests submitted properly and approved before payment?	

Goods Received	YES/NO
Are all materials inspected for condition and independently counted, measured, or weighed when received?	
Are receiving reports used and prepared promptly?	
Are receiving reports subjected to the following: • Pre-numbering and accounting for the sequence of all numbers? • Copies promptly provided to those who perform the purchasing and accounts payable function? • Controlled so that liability may be determined for materials received but not yet invoiced?	

Employees	YES/NO
Are all employees' job references checked?	
Are individual personnel files maintained?	
Is access to personnel files limited to a person who is independent of the payroll or cash functions?	
Are wages, salaries, commission and piece rates approved?	
Is proper authorisation obtained for payroll deductions?	
Are there adequate time records for employees paid by the hour?	
Are salespeople's commission records reconciled with sales records?	
If employees punch time clocks, are the clocks located so they may be watched by someone in authority?	
Are time records for hourly employees approved by a foreperson or supervisor?	
Are there appropriate controls in place to ensure the absence of any employee is noted?	
Is the clerical accuracy of the payroll checked?	
Are payroll registers reviewed by a responsible person?	
If employees are paid in cash, is the cash requisition compared to the net payroll?	
Is there control over unclaimed payroll cheques?	
Do you cross-train staff in accounting functions?	

TIP

For all those questions in the checklist that have not been answered with "yes", review which ones are applicable to your organisation. Then make an action plan that includes who will be responsible for implementing each policy and procedure and gives a due date for completion.

Reviewing this checklist and taking appropriate action will ensure you have good financial controls in place for your business.

Appendix 1 – Summary of Hints and Tips

Business Finance Basics	Implementing good financial practices in your business will provide sound financial information that can identify current issues and be used to plan for the successful financial future of your business.

Chapter 1 - Understanding Financial Statements	Financial statements provide information on how the business is operating financially and why. Ensuring financial statements are produced regularly will provide financial information for continual improvement of business operations.

Topic	Hint	Tip
Profit and loss statement	Only those businesses that have goods (products) to sell will use the calculation of cost of goods sold.	Regularly (monthly) produce profit and loss information and compare against previous months' activities to ensure your profit expectations are being meet.
Balance sheet	The diagram on page 8 shows how the balance sheet works. The business requires assets to operate and these assets will be funded from the equity in the business, the profit from the operations of the business or by borrowing money from external parties.	A prosperous business will have assets of the business funded by profits rather than being heavily reliant on funding from either external parties (liabilities) or continual cash injections from the owner (equity).
Statement of cashflow	Statement of cashflow only shows the historical data and differs from a cashflow forecast.	Use the cashflow statement to analyse whether you are spending more than you are earning or drawing out too much cash from the business.

Chapter 2 - Assessing the Financial Health of Your Business	Financial ratio analysis will provide the all-important warning signs that could allow you to solve your business problems before they destroy your business.

Topic	Hint	Tip
Liquidity ratios	Use current and quick ratios to assess whether your business has adequate cash to pay debts as they fall due.	The quick ratio will give you a good indication of the readily available cash to meet current debt obligations.
Solvency ratios	Use these ratios to ensure your business has adequate long-term cash resources to cover all debt obligations.	These ratios indicate the extent to which the business is able to meet the debt obligations from all sources other than just cashflow, as is the case with liquidity ratios.
Profitability ratios	Use gross and net margin calculations to measure the profitability of your business operations.	Comparing your net and gross margin percentages to those of other businesses within the same industry will provide you with comparative information and may highlight possible scope for improvement in your margins.
Management ratios	Use the number of days for stock, debtors and creditors to calculate the cash conversion rate for your trading activities.	Comparing your management ratio calculations to those of other businesses within the same industry will provide you with comparative information that may highlight possible scope for improvement in your trading activities.
Balance sheet ratios	Use the return on assets and investment ratios to assess the efficiency of the use of your business resources.	These ratios will provide an indication of how effective your investment in the business is.

Chapter 3 – Budgeting	A budget is the future financial plan of the business. It is where the strategic plans are translated into financial numbers to ensure these plans are viable.

Topic	Hint	Tip
Profit and loss budget	By preparing a profit and loss budget annually, you will be in a position to determine if your future business plans will support the ongoing activities of your business.	An independent profit and loss budget can be developed for separate projects to assess the financial viability of each project.
Assumptions	All assumptions made during the planning process of preparing budgets should be realistic and documented.	When documenting your assumptions, include both the risk assessment of each assumption and the anticipated action required to match the risk. That way, where actual events do not match your assumptions, you will be well prepared and have an action plan already in place.
Monitoring and managing budgets	Remember, the more regular the reports, the quicker operations can be reviewed for financial impact and action can be implemented immediately where required.	Regular review of budget against actual results will provide information on whether your business is on track to achieve the plans formulated when you first prepared your budget.

Improving Business Finances	Improving business finances means you need to take a practical approach to implement new processes that allow you to monitor the key aspects of your business: profitability and cashflow.

Chapter 4 – Maintaining Profitability	It is very easy for profitability to be eroded if you do not measure and monitor on a regular basis. Therefore, it is important to understand how to use the tools available to continually evaluate the profitability of your business.

Topic	Hint	Tip
Profitability measures	Using the profitability measures provided will ensure you are aware of any reduction in profit as it occurs and understand what level of sales is needed to ensure the business will generate a profit.	Compare your profitability measures to those of businesses within the same industry to ensure you are being competitive and achieving maximum profit potential.
Discounting sales	You may like to consider offering your customers add-on services as an alternative to offering discounts.	Always calculate the impact on profitability before offering discounts.
Expense management	Keeping a close eye on your expenses will ensure you maintain the profitability of the business.	Look for opportunities to join with other businesses for group buying that can provide discounts on your expenses.

Chapter 5 – Improving Cashflow	Working capital is the short-term capital required by the business for day-to-day operations. This includes stock, work in progress, payments to suppliers and receipts from customers. By working your cycle more efficiently, you have cash more readily available to use in other parts of the business.

Topic	Hint	Tip
Managing stock	Setting up good stock-control procedures will ensure cash is not tied up in holding unnecessary stock.	See page 33 for complete list of tips
Managing payment to suppliers	Setting up good management procedures will ensure you get the most out of your relationship with suppliers.	See page 37 for complete list of tips
Managing work in progress	The key to managing work in progress is to have a good record-keeping system.	See page 40 for complete list of tips
Managing debtors	Ensure you have good procedures in place to encourage prompt payment.	See page 43 for complete list of tips
Working capital cycle – cash conversion rate	Calculate the cash conversion rate and compare this with the standards within your industry. Using each of the tips in the sections above, identify which areas of the cycle are problematic and prepare an action plan to improve the cash conversion rate	Regularly calculate your cash conversion rate and implement improvement to your working capital to "free up" idle cash that is not being used within the business. This will reduce the need to borrow additional funds to support the operations of the business, decrease reliance on funds from lenders, and reduce any interest expense incurred.

Chapter 6 – Managing Cashflow	A business can be profitable but still have cashflow issues. It is important to implement procedures in your business that will ensure cashflow is appropriately managed.

Topic	Hint	Tip
Cash and profit	Cash does not always equal profit!	The timing of when cash is received is the most important issue when managing cashflow
Cashflow drivers in your business	Cashflow is the lifeblood of every business. A profitable business can still suffer from shortages in cash, so it is important to understand what drives your cashflow.	The importance of knowing what the key drivers of your cashflow are should not be under-estimated. In order to maintain adequate cashflow, these drivers should be a priority for your business and be well managed.
Cashflow forecasting	Remember, cashflow is all about timing and the flow of cash, so when preparing your cashflow forecast, make sure you are as accurate as possible on the timing of the cashflows.	Once the forecast is completed, you can run some “what if” scenarios to measure how reactive your business cashflows will be to certain changes in events, such as a decrease in sales, or an increase in fuel costs. This will show you how quickly you may run out of cash if any of these events occur.

Financing Your Business	Financing your business is an important part of good financial management. Not only having access to finance, but also being able to choose the most appropriate method of finance for your business will result in continued growth and profitability.

Chapter 7 – Debt, Equity or Internal Funds?	A key requirement to ensuring you choose the right funding is to make certain you fully understand the differences between debt and equity and to consider the implications of each for you in your business.

Topic	Hint	Tip
Comparing debt finance, equity investment and internal funds	To fully understand the implications of choosing debt, equity or internal sources of finance to fund your business, ask yourself what would happen if something went wrong. The answer will help you in make the right choice.	Generally, a business would aim to maximise the use of debt finance to fund its operations, as long as the business can service the level of debt and it has sufficient security to support the funding. The business owner would retain the benefits of ownership in respect of growth and profitability of their business.
Deciding between debt and equity	In deciding whether or not to seek an equity party, you need to consider both the financial and non-financial outcomes.	You may find your ability to raise debt is improved with equity investment.
Understanding debt financing options	It is important to review alternative finance products from different lenders and ensure you are comparing apples with apples.	Ensure the type of financing undertaken matches the reason for seeking finance. A general rule of thumb is to match the term of the loan with the length of the life of the asset you are funding.

Chapter 8 – Transactional banking to suit business needs	Transactional banking forms part of the overall financing of your business. The everyday banking requirements should be considered carefully to ensure that the payments in your business are efficient and effective

Topic	Hint	Tip
Transactional banking products	Choosing the most appropriate transactional banking products will assist in managing cashflow and improving profitability.	Your banker can assist you in choosing the most appropriate transactional banking products for your business.
Merchant facilities	Merchant facilities provide a real benefit to your business cashflow: your customers do not necessarily need to have cash in the bank to pay for your goods or services.	By introducing merchant facilities, it is possible your business will benefit from quicker payment, significant reduction in invoice queries and credit control calls and, of course, improved cashflow.
Transactional fees	Regular review of your transactional banking services will guarantee you know how much you are paying for these services, and ensure you are using transactional services that best suit your business.	By allocating all bank fees in a separate account, you will be able to clearly identify any increases in fees that could be impacting your profitability.

Chapter 9 – Importing and Exporting Finance	International trade finance products are specifically designed to assist importers and exporters in managing risk and improving cashflow for their business.

Topic	Hint	Tip
Foreign currency payments	By hedging your international currency payments, you will reduce the risk of negative impact on profitability.	Often using a combination of hedging products will provide the best protection over movements in foreign currency.
Alternative methods to manage foreign currency payments	Foreign currency payments can also be managed by implementing alternative payment methods.	It is advisable to speak to your banker to determine the best alternative to manage your international trade payments.
International trade finance	Trading internationally can be a real strain on cashflow. If you can negotiate with your supplier or customer to use trade finance products, you can free up cashflow to use on other parts of the business.	For exporters, the most favourable method of payment will be prepayment, and for importers, open account (paying on receipt of the goods).

Managing Lenders	Many people in business over estimate how much a banker knows about their business or industry, and because of past actions by some banks, they also can feel somewhat intimidated. However, if you take the time to educate your banker, they can be an asset to your business.

Chapter 10 – Applying for a Loan	The preparation and presentation of a loan application are critical to the success of the application. By spending appropriate time on these, you ensure the application will provide a good indication to the lender that you run a well-organised business.

Topic	Hint	Tip
Preparing a loan application	If you follow the guidelines as detailed in this chapter, you will be well prepared, better informed and hence more confident in your approach to potential financiers.	The more information you present to the financier about your industry, the company, key management, and your marketing plan, the easier their job becomes to review and support the loan application. Loan officers agree that a complete, well- prepared loan application will go to the top of the pile.
Presentation of the loan application	Make sure you understand all the financial information that has been prepared and is being presented.	When applying for a loan, always meet with your banker in person to discuss the application

Chapter 11 – Refinancing Your Debt	Often small businesses have the same banking facilities years on from when they started. A review of existing facilities may highlight that the current facilities and structure needs to be changed to meet the change in business operations.

Topic	Hint	Tip
How refinancing works	Refinancing can involve a number of alternatives. To achieve the best outcome, ensure you understand all the alternatives before committing to a new lender.	Make a list of the reasons why you might consider refinancing your loan to compare with the loan offer you receive
Benefits of Refinancing	After carefully undertaking a cost–benefit evaluation of refinancing, you may find this brings a range of new opportunities to your business.	Refinancing a strong healthy business may also mean there is an opportunity to separate your personal assets from security offered if the value of the business assets (i.e. commercial land and building, debtors, fixed assets etc) are sufficient to cover the borrowing.
Common dangers in refinancing	Ensure you have undertaken sufficient review of your circumstances prior to making any commitments for refinancing, as there are many pitfalls that may impact any perceived benefit.	Make a list of all the points on page 95 and note the pros and cons for each point to help assess whether to refinance.
Switching Banks	Use the Small Business Victoria Loan Finder at: http://www.business.vic.gov.au/scripts/nc.dll?BUSVIC:STANDARD:1001:pc=PC_62522.html to help assess what each bank can offer.	Comparative information on bank finance is available on the CPA Australia website at: https://www.cpaaustralia.com.au/cps/rde/xchg/cpa-site/hs.xsl/knowledge-leadership-toolkit-guides-small-business-indicators.html

Chapter 12 – Managing banking relationships	Good relationships with your bankers will ensure they understand your business and are in the best possible position to provide advice and support when needed.

Topic	Hint	Tip
Annual review	Being well prepared for the annual review will show the bank you understand their requirements and indicate good management practices.	At the annual review time, the bank is likely to require up-to-date financials and all other relevant information that summarises the last twelve months of your business operations.
Continuing relationship	Keeping your bank well informed of your business activities and performance will ensure they are ready to respond to any request you may have.	Bank managers are often working with other businesses in similar industries and can be a source of useful information for your business.
If difficulties arise	If your business is having problems, such as difficulty keeping up repayments, discuss with the bank immediately so they can work with you to find a solution.	Bank managers are more ready to provide any required assistance, such as a renegotiation of repayments, if they are told about a deteriorating position rather than having to find out about it themselves.

Better Business Financial Management	When you are using financial information to make decisions, it is important that policies and procedures are in place to ensure the information is complete and accurate and will lead to the correct decisions.

Chapter 13 – Financial Controls	Financial controls are policies and procedures that are used in your business to protect your assets and to support good financial reporting.

Topic	Hint	Tip
Benefits of financial controls	If you are using inaccurate financial information for decision-making, you could be making the wrong decisions.	Good financial controls will protect your investment in your business and ensure the business runs more efficiently, resources aren't lost and there are fewer unpleasant surprises.
Financial controls checklist	Using the checklist will help you determine which financial controls are relevant for your business and highlight the areas where you can improve your financial controls.	For all those questions in the checklist on pages 103-106 that have not been marked "yes", review which ones are applicable to your organisation. Then make an action plan that includes who will be responsible for implementing each policy and procedure, and gives a due date for completion.

Appendix 2 – Sources of Further Information

Find out more at Financial Planning. On the Business Victoria homepage, click *Starting & Managing a Business*, then *Financial Planning*.

Government Agencies

Victorian Business Centres (VBCs) can assist small and medium businesses to flourish. Centres are located throughout Victoria and have an array of services available, from books to computer listings of all the required **licences** for a business. They also have a bank of consultants they recommend for specific requirements. A list of VBCs can be found at the conclusion of this guide. Victorian Business Line, Hours: 8am–6pm Monday to Friday

Telephone: 13 22 15
Website: www.business.vic.gov.au

Small Business Workshops & Seminars
The *Small Business Workshops & Seminars* Program provides intending business owners, start-up businesses and existing small businesses with vital information through practical workshops and seminars.

Workshop topics include: Buying a Franchise, Business Planning Workshop and Marketing for Growth. Seminar topics include: Buying a Franchise, Business Planning Basics, Marketing Basics, Get Your Business Organised and Networking.
Website: www.business.vic.gov.au/workshops

Small Business Development Program
The Melbourne City Council runs a program each year in March, July and October to encourage and attract new, sustainable small businesses that will add value and diversity to the City of Melbourne business landscape.
Website: www.melbourne.vic.gov.au/enterprisemelbourne/BusinessSupport

Skills for Growth
Skills for Growth will help Victorian small to medium sized businesses, including those in the community sector, with workforce skills development. It will provide a team of independent workforce planning and training specialists to deliver free assistance to the business. Through the program, eligible workers will be able to access government subsidised training solutions.

Skills for Growth is part of the Victorian Government's skills reform package with $52 million committed to the program to address the skills needs of business and the training needs of the workforce.
Website: www.business.vic.gov.au/skillsforgrowth

Plan to Succeed
A comprehensive guide introducing the essential steps in business planning and how to write a business plan. Over 80 information sheets and booklets on a variety of small business management subjects are also available.
Website : www.business.vic.gov.au

Business Licence Information Service (BLIS)
Helps identify the state, local and federal licences and state **codes of practice** needed to start and operate your business in Victoria. View details for your business or create a tailored report that includes application forms.
Website : www.business.vic.gov.au/blis

Small Business Mentoring Service
Provides access to experts to help start a small business or to improve the performance of an existing enterprise. Mentors have backgrounds in a broad range of industries and specialities such as marketing, sales, finance and franchising. The **Small Business Mentoring Service Inc** delivers this program.
Website : www.sbms.org.au

Koori Business Network
Support and referral services for existing and potential **Koori business operators** through programs to assist communities and businesses turn their skills and expertise into sustainable economic businesses.
Website :www.business.vic.gov.au/kooribusiness

Grow Your Business Program
Provides assistance, including **grant subsidies**, to financially viable Victorian businesses that can demonstrate a commitment to productivity gains, increased exports or import replacement, application of **new technologies** and **innovative practices**.
Website :www.business.vic.gov.au/gyb

Victorian Business Consultation Database (BCD)
The Victorian Government is inviting all small to medium sized businesses to have their say on government regulations and licensing. As a business owner, you can chose to lodge your business contact details in the BCD and give us permission to seek feedback when regulatory issues arise, or you can make a suggestion without registering your details in the database.
Website: www.business.vic.gov.au/bcd

Export Assistance Services
The Victorian Government helps companies explore and develop export opportunities through a range of programs including government export grants and assistance programs; guides for developing strategies to commence or expand exports; and export-related contacts and assistance. The Opening Doors to Export website provides more information on these programs and other export-related topics.
Website: http://export.business.vic.gov.au

Austrade
Austrade Trade Commissioners are co-located at a number of Victorian Business Centres and can assist potential and existing exporters with general export information, and advise on access to Commonwealth export assistance programs.
Website :www.business.vic.gov.au/vbc

Industrial Relations Victoria (IRV) Information Services
IRV provides information services to employees and employers about good industrial relations practices and statutory rights and obligations. (Covers child employment, outworkers, long-service leave and low-paid workers.)
Website :www.irv.vic.gov.au

Child Employment Permits
There are regulations about employing children under the age of fifteen in Victoria. In many situations, there is a legal requirement to obtain a Child Employment Permit before a child can be employed. For more information please contact IRV.
Website: www.irv.vic.gov.au

Science Technology Initiative Infrastructure Grants Program
Invests in collaborative projects, between industry and research sectors, that enhance opportunities for the translation of knowledge and research to the marketplace. Grants are aimed at building capabilities that increase the movement of new technologies or discoveries towards market testing and uptake.
Website :www.innovation.vic.gov.au

ICT Trade Fairs and Missions
Provides financial assistance for Victorian information and communications technology (ICT) companies to attend recognised overseas trade fairs and missions.
Website :www.mmv.vic.gov.au/tradefairs

Centre for Innovation and Technology Commercialisation
The Centre supports and promotes an entrepreneurial culture in Victoria by showcasing innovative businesses, activities and new technologies.
Website :www.innovation.vic.gov.au

Regional Development Victoria (RDV)
The Government's lead agency in developing rural and regional Victoria, with a focus on building stronger economies, communities and infrastructure. RDV assists in the coordinated delivery of Government programs, services and resources in provincial Victoria. Programs include:

- Economic development programs which provide assistance to encourage councils and regional development bodies to work together
- Assistance to interface with councils for projects that promote and facilitate economic development

The Community Regional Industry Skills Program (jointly administered by RDV and the Department for Victorian Communities) which brings together local employers, labour market and education providers to address local skill shortages.
RDV is widely accessible at Victorian Business Centres located across Victoria. (See back page for listing www.rdv.vic.gov.au)

Other useful links

Small Business Newsletter
www.business.vic.gov.au

Business Enterprise Centre Victoria
www.becnvic.com

Public Holidays
www.business.vic.gov.au/publicholidays

Government Services for Aboriginal and Torres Strait Islander peoples
www.indigenous.gov.au

Victorian Business Centres

Ballarat Victorian Business Centre 48 Sturt Street Ballarat Vic 3350 Tel: (03) 5320 5900 Fax: (03) 5320 5998	**Bendigo** Victorian Business Centre 46 Edward Street Bendigo Vic 3550 Tel: (03) 03 5442 4100 Fax: (03) 5442 5452
Bundoora Victorian Business Centre Suite 16 Level 1, 20 Enterprise Drive Bundoora Vic 3083 Tel: (03) 9935 0600 Fax: (03) 9466 7367	**Dandenong** Victorian Business Centre 314A Thomas Street Dandenong Vic 3175 Tel: 13 22 15 Fax: (03) 9794 5644
Geelong Victorian Business Centre 69-71 Moorabool Street Geelong Vic 3220 Tel: (03) 5229 0641 Fax: (03) 5229 9503	**Melbourne** Victorian Consumer and Business Centre 113 Exhibition Street Melbourne Vic 3000 Tel: 13 22 15 Fax: (03) 9651 9725
Mildura Victorian Business Centre 131 Langtree Avenue Mildura Vic 3500 Tel: (03) 5051 2000 Fax: (03) 5051 2020	**Shepparton** Victorian Business Centre 3/164 Welsford Street Shepparton Vic 3630 Tel: (03) 5821 1811 Fax: (03) 5822 2554
Traralgon Victorian Business Centre 33 Breed Street Traralgon Vic 3844 Tel: (03) 5174 9233 Fax: (03) 5174 7845	**Vermont** Victorian Business Centre 520 Canterbury Road Vermont Vic 3133 Tel: 13 22 15 Fax: (03) 8872 7445
Wangaratta Victorian Business Centre 27-29 Faithfull Street Wangaratta Vic 3677 Tel: (03) 5721 6988 Fax: (03) 5721 2265	**Wodonga** Victorian Business Centre 6/22 Stanley Street Wodonga Vic 3689 Tel: (02) 6056 2166 Fax: (02) 6056 2334