BRIEFINGS

WATERHOUSE
CHARTERED ACCOUNTANTS

EDITION #28 MAY 2016

Is Fast Growth Good?

Most people are not surprised when a start-up business fails. But it's not just start-ups that fail from growing too fast; it's also a common cause of business failure for mature businesses.

Start-up businesses often fail because they are under-capitalised. They grow until the money runs out and then they can't afford to fund further growth. The banks refuse to lend to them as they have no history and no assets to leverage, and then they die. It's an easy trap to fall into. The entrepreneurial spirit that drives people to start up a business is often the same spirit that keeps them focussed on a growth path. The mentality is that the faster you drive sales and bring in the cash, the more successful the business (and the entrepreneur) will be. However, this cycle of sales and profit is missing two key components: financial, and cash flow management. A successful and sustaining business has all of these elements.

For the more mature business, growing too fast is often the result of unplanned growth opportunities. It's ironic that seizing a major sales contract or a big new client can be your business's ruin, but it's more common than you think. More often than not it's an issue that business operators don't identify until it is too late.

Many business operators are very good at what they do. Most have an excellent knowledge of the business they conduct and understand their products and services. Most also have an in-depth knowledge of sales performance and revenue. Few, however, have a high level of financial management expertise, so when a big new opportunity presents, critical financial questions are not asked. As a result, there can be a sudden and unintended impact on their financial position. A rush of sales might be a great thing, but it is not always counterbalanced by a rush of income and profit. Free cash and liquidity are the victims.

Big one-off opportunities can also be dangerous because they are rare. For businesses without strong financial management and control, there is simply no way of understanding what impact the opportunity will have until they have experienced it. With no background history to rely on, the warning signs of impending financial crisis don't appear.

Sudden growth comes at a cost. That cost can be at a profit or at a cash flow level. Profit and cash flow are not the same and where operators don't have a lot of financial expertise they generally rely on profit analysis without considering the cash flow implications. You need to understand the cash cycle and its timing within your business.

The first step is to understand that sudden change creates a different dynamic and brings cost and cash flow implications with it. It's essential not to embark on sudden change without identifying what these implications are.

Let's look at an example: Jonathon runs a typical small business. Since taking over the established business a year ago growth has accelerated. The primary product of the business is brought in from overseas. The business is predicated on a budgeted turnover of $70,000 - $100,000 per month. The working capital in place accommodates the business operating at this level, which is already a step up from where it was when he bought it.

Jonathon knows the business has a lot of potential and he's been working hard to fulfil its promise. He's ecstatic because he's brought in five major sales all within the $50,000 - $200,000 range and all expect delivery within the coming three months. While the big sales required a dip in the gross profit margin, it's still do-able.

If all of the orders come through, the impact of the new sales will take his turnover from its current level of $100,000 per month to an average of $250,000 per month for the next 3 or 4 months. If you imagine yourself in Jonathon's place it would be hard not to be impressed with your efforts, wouldn't it? What a boost to the company.

Now add in another factor. The primary product is purchased from the supplier without trading terms so the outlay for any major sale is in advance. As a result, the cash flow implications of the time between each sale, the purchase of the product from the supplier, fulfilment and payment by the customer is critical to understand. For Jonathon, the highest risk is the major outlay of cash required to fulfil the sale. He cannot buy time.

When Jonathon had a cash flow analysis put in place to determine the impact of the new sales it revealed that he needed $200,000 to $300,000 more cash than he had. He knew it might be tight, but didn't realise the situation was that stark. As a result of the analysis, Jonathon was able to work with the customers to stage the orders and manage the cash flow requirements.

Had he fulfilled the sales without the analysis, he would have had a funding gap of approximately 60 days where he was exposed by $250,000 without the capital base to support him.

While the details might be different, situations like Jonathon's are not uncommon. The problem is that unless you have strong security, the chance of any bank giving you an increase in funding is unlikely. Banks want to lend to businesses that have good financial management. If you approach them once a problem such as Jonathon's has occurred, you have already proven the case in the negative and set yourself up for rejection.

In the example above, cash flow was the major issue. In others it is profit. Large customers with large orders may expect you to cut your margin or they might ask you to discount if they 'up the order'. The danger is that you, or your sales people, get carried away with the headline number and don't look at the profit contribution. Some sales, even big sales, are simply not worth it as you can't trade below a certain profit level. For businesses with higher fixed costs your ability to negotiate your margin is less flexible than those with higher variable costs. The key is to know your break-even point before entering into any deals.

Discounting can also be its own trap. For example, if your margin is 40% and you reduce your price by 10%, you need a 33% increase in sales volume to maintain your profit level.

Warning on Bank Advice to Business Owners

Some banks are advising customers with business accounts to transfer excess cash to pay down the business owner's home loan. While it might sound like common sense to use the excess cash in your business, there are significant potential problems for business owners who do this.

Money in your business account is the money of the business, not your personal cash. You can't just take it out and move it around at will, even if it is your business.

If you run a company, there are a set of tax rules called Division 7A that apply. Division 7A is a particularly tricky piece of tax law designed to prevent business owners accessing funds that have not been taxed at their individual tax rate – only the corporate rate. While these amounts are often debited to the shareholder's loan account in the financial statements, Division 7A ensures that any payments, loans or forgiven debts are treated as if they were dividends for tax purposes unless there is a valid shareholder loan agreement in place.

So if you take money out of your company bank account to pay down your personal home loan, this amount might be treated as a deemed dividend. That is, you need to declare this amount in your personal income tax return and the dividend is not frankable. This means that even though the company might have already paid tax on this amount, you will be taxed on it again without the ability to claim a credit for the tax already paid by the company (basically leading to double taxation).

If you have taken money out of the company account for personal purposes you can either pay back the amount or put a complying loan agreement in place before the earlier of the due date and actual lodgement date of the company's tax return for that year. To be a complying loan agreement the agreement requires minimum repayments to be made over a set period of time and the minimum benchmark interest rate to apply – currently 5.45%. The rules are also very strict when it comes to loan repayments because these can actually be ignored if it looks like you are planning to borrow a similar or larger amount again from the company.

A similar issue can also arise if you transfer funds from a trust bank account, especially where that trust already owes amounts to a related company in the form of unpaid distributions.