Surviving the pitfalls of small business

Businesses go through stages of growing up, each stage posing different problems

By Bernadette Mc Grory – Farrell CPA

When speaking to people who's businesses have failed it is not unusual to hear them blame everything and everybody but themselves. Some might say that they don't know why they failed and indeed there might be some honesty in that, particularly where the proprietor's inexperience in basic business skills was the prime cause of failure.

The reality is that most business failures stem directly or indirectly from bad management. This sounds all too obvious and even trite but in small businesses particularly, the proprietor is the only driving force for all activities and his/her inexperience can sow the seeds of early failure.

The gaining of experience has an inherent time element and the small business proprietor is always short on time. Business people should recognise that businesses, like people, go through stages of growing up; each stage posing different problems. Knowing where you are on the life cycle will help enormously.

Remember your business will not stand still, it will either go backwards or forward.

Stages	Problems
1) 1 to 3 YEARS	One man band Under capitalised Lack of reserves Inexperience Trying to cope with everything Establishing a place in the market
2) 3 to 5 YEARS	Employees Delegation Rising overhead costs Overtrading Crisis Management
3) 5 YEARS	Financing expansion Maintaining Competitiveness Controlling the business Indecision on future path

Hopefully, people who enter business have at least one pertinent acquired skill in which they received training, and a majority of the appropriate personal qualities needed to stay the course. What they don't realise is that they must quickly learn the other essential skills which are basic to any business operation.

These essential skills might be listed as

1. An understanding of and ability to manage their business finances.
2. An understanding of their markets.
3. Buying and Selling skills.
4. Costing and Pricing capabilities.
5. Budgeting and Planning processes.

To accept their importance and then take positive action to improve knowledge in these areas can be considered the first step towards professionalism. The second step is to actually put into practice what they have learnt.

Carelessness or indifference to this process of learning, - and believe me, it is a continuous process - will sooner or later lead to one or more of the specific causes of failure.

The Ten Most Common Causes of Business Failure

1. Cash Flow Problems

Cash is the life-blood of any business. No cash - no business - it's as simple as that

Cash is the most critical asset of any business and by far the most important. Too many people concentrate on making profits, but profits are not much use if they are tied up in debtors, work-in-progress or equipment. This particular problem is common to almost every business, manufacturers, contractors, retailers, even accountants and solicitors.

Sometimes it is a seasonal problem, in other words cash is tight at certain times of the year only - in other cases cash shortages are always present and a continuous headache.

Many profitable businesses go under due to bad cash control and not because of inadequate profits.

Unlike some of the other problems we will be discussing, the cash flow problem is very easy to recognise - you just have no cash and your business is at risk . You may have plenty of stocks, good plant and equipment, large amounts of debtors and even a good profit record, but if you have not sufficient ready cash to pay your way - you have a problem and this problem can not go unsolved for very long.

Shortage of cash is the immediate cause of almost every business failure - hence the importance of cash planning and control.

2. Lack of Capital

Most new companies are under capitalised. If this is how your business started off, it is very difficult to correct it. It is crucial to be brutally honest about how much money will be needed to fund the operation of your business for the first year at least, and then to discount even further your expectations of cash inflows.

3. Lack of Current Regular Financial Information

It is impossible to overstate how inadequate reliance on Annual Audited Accounts is, for all stages of business. The

Annual Audited Accounts, by the time they are prepared are already historic and out of date. Successful businesses have perfected the knack of having key “red hot” financial indicators on a monthly basis. For most small businesses a one-page monthly report showing turnover, gross profit and net profit margins, debtor/creditor/stock days, bank balances and taxes outstanding, is all that is needed. But the key thing most people overlook is to use this current financial information to predict difficulties in the coming months and take corrective action.

4. The BIG Contract

If we are being honest, this is the dream that gets most of us out of bed in the morning, the "BIG ONE" , the contract which would really set you up for good! You have beaten all your competitors at last, but more than likely you have beaten yourself and your business.

You should never take on a contract or "Line of Work" of such size that if anything goes wrong during the contract, your entire business is mortally wounded, but very few small businesses have the strength of character to walk away from such an opportunity.

If the contract or work is of very long duration you may lose contact with your other customers and even if the contract is finished successfully you may find yourself almost forgotten in the market place.

It is important to know exactly how you have beaten your competitors. Have you under-priced? Have you the plant/ machinery or stocks to complete the work? Do you have to purchase new plant and machinery and so deplete your reserves? Have you other work for this plant/machinery?

Is there retention money? - is this your profit?

5. Small Customer Base

Over reliance on one or two large customers. If they go - you go.

The same principle applies here as in the "BIG CONTRACT"

Endeavour to broaden the base of your activities so that you are not relying on one or two large customers or indeed on one or two large suppliers. You cannot afford to have the success of your business depending on decisions made by one or two people outside your control, even by a Government Department.

6. Overtrading

This occurs when a business expands faster than it's capital base. Turnover increases, working capital requirements increase, bank loans rise, interest payments grow and the company's cash reserves or profits do not increase at the same rate. Eventually it cannot meet its commitments.

7. Costing and Pricing

Whilst these are in the one sense quite separate subjects they are inevitably linked by the end profit result. It is still sad to relate that a large number of businesses simply do not know the real cost of producing their product or service. The likelihood is that they are under-costed. Knowing what price to set and when to change this price requires a combination of judgement, intuition and skill. Much of your success in business will depend on how you price products or services.

If your prices are too low you will not cover expenses, if your prices are too high you will lose sales volume.

In both cases you will not make a profit.

Given the importance of costing and pricing, it is surprising how unorganised and haphazard these tasks are carried out in many firms.

8. Inability to Generate Sales

This is a major cause of business failure. Little or no market research is a contributing factor to sales not being achieved to plan and indeed in many small businesses there is not even a plan.

Marketing is a skill that few small business proprietors are trained in - and of which some lack a proper understanding.

I would like to draw your attention to some vital questions which proprietors should ask themselves and seek answers to:-

- Do you really understand the market you are in?

Try writing down a statement in clear terms defining your market.

- Do you know your target customer groups?

Knowing these will enable more specific selling strategies to be devised and used.

9. Practical Planning For Growth

Although Management should not have to do these calculations themselves, they should have sufficient understanding of the financial implications involved in strategic and marketing decisions to ensure that these issues are addressed. Strategic and Marketing decisions made in isolation of financial information will always result in disappointing bottom line results at best, or cash flow shortages, overtrading and eventual collapse, at worst.

The implications of growth for every business involve some, and usually all, of the following:

1. Increased working capital requirement
2. Increased labour numbers or skills requirement
3. Increased fixed assets requirement
4. Increased capital funding requirement
5. Less time, everyone is busier.

In making strategic decisions management need to be able to take account of the following:

1. How do you calculate the increase in working capital required to finance every €1000 increase in sales?
2. Who funds the increased working capital,
   a. the bank overdraft,
   b. increased creditor strain,
   c. the revenue commissioners?
3. Debtors management, what is the margin of error if new customers don’t pay within the agreed terms? At what point does a particular customer cease to be profitable?
4. How are capital funding decisions made? Does management understand the lenders perspective?

Some of the issues which management need to be able to address are:

1. Which product or service is the most profitable for the company? How are fixed costs absorbed? What is the contribution or gross margin from each product or service?

2. Can management easily do "make or buy" calculations?

3. What are the additional costs involved in new markets? What will be the impact on the bottom line profitability?

4. What is the company's limiting factor, e.g. machine output/ labour hours/ square footage/ distribution channels?

Attention and correction to these elementary matters costs little but could keep your existing customers and get many new ones.

Remember that everything you or your staff do, say or write in the course of your work creates some sort of image with the customers - make sure it is the right one.

10. Excessive Personal Drawings

Many a successful small business has been ruined by the proprietor and his family living beyond their means. Personal drawings should certainly not exceed profits under any circumstances and the prudent business person should ensure that sufficient profits are retained in the business for future developments.

This is a problem that most family businesses suffer from.

You may claim that your business "owes" you a living and perhaps it does - but the quality of that "living" depends entirely on your ability to generate profits, and bears no relationship to the standard of living you want.

Conclusion

There is no guarantee of success in business. Some companies will get lucky but depending on luck is a risky pastime! The risk of failure can be reduced – but not eliminated – by planning along the lines outlined above. But remember, failing to plan is effectively planning to fail!

Bernadette McGrory-Farrell, CPA, is a partner in W.O. McGrory & Co, Certified Public Accountants, Drogheda, Co Louth, and is also the Managing Director of Omac Management Services Ltd.

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W.O. McGrory & Company

Certified Public Accountants
and Registered Auditors

Authorised by the Institute of Certified Public Accountants
in Ireland to carry out Investment B

OMAC Business Centre
Old Nangor Road,
Clondalkin,
Dublin 22

Tel: 01-457 4844
Fax: 01-457 2419

OMAC Business Centre
Carlington Lodge,
Dublin Road,
Drogheda, Co. Louth

Tel: 041-983 6707
Fax: 041-983 6273

Email: info@mcgrory.ie
Web: www.mcgrory.ie

artners:
P.A. Farrell CPA FCCA   B. McGrory-Farrell CPA MBA
RJ. McGrory CPA   A. Fallon CPA   D. Power CPA