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FINDING THE HIDDEN PROFITS IN YOUR BUSINESS QUICKLY



| By **John Scutt** |

The last decade was one of unprecedented growth for many organizations. In that environment, the need to take measures that maximized profitability became secondary to sales growth.

Since late 2007, however, the global financial crisis (GFC) has produced a sluggish economy in which top-line sales growth has slowed. Many organizations face the prospect of slower or negative earnings, and respected financial analysts are predicting further difficult times ahead.

What boards and management must now do is relearn how to improve profitability quickly in an environment where sales are going to be sluggish at best.

Top-performing businesses will grow in a recessionary environment, whether through sustainable growth or acquisition. Successful businesses will not hit the pause button.

Review Your Business Strategy

The first step an organization must take before it can successfully implement a profit-improvement program is to undertake a health check of its current business strategy. It is often understood that there are three basic models for a successful business strategy:

- Cost Leadership
- Product Differentiation
- Niche Market Domination.

The challenge for any organization is to find and implement the right model for its resources. Even if your organization has the essential skills and experience for an internal business-strategy review, it is recommended you engage an external business advisor. An experienced advisor works with the organization, identifying the resources required to improve financial performance and give staff the skills development they need to give you a long-term advantage over your competitors.

Basic Business Principles: A Checklist

It is recommended organizations are put through a basic business-principles checklist to get the board and management teams thinking beyond their comfort zone. The answers to the following questions will help identify sources of hidden profits.

Is your product or service relevant?

That is, does it fulfil a need, offer a benefit, show innovation and differentiate itself.

Is a marketing plan in place?

Unless the product or service is unique (unlikely), you must advertise: be first, different, daring and memorable.

Is there sufficient working capital?

The working capital base is critical and can vary depending on the business initiatives.

Does your business have the right balance of people?

The business may have become bloated with underachieving staff. Salary levels may not be sustainable. If there is a need for change, then select new staff that are smart, reliable, coachable, trustworthy and will fit into the business culture. Be sure to keep all staff motivated and happy.

Are your business partners adding value?

It is important to have business partners who provide complementary products and services that add credibility and capability to your business. And you should share a similar philosophy and approach.

Are your internal financial controls and cash-flow monitoring working?

Any business that is not watching its spending closely is looking for trouble. Do not rely on your bank to bail you out of a cash hole!

Does the business plan have continued improvement, innovative systems in place?

Your business processes and procedures should follow ISO 9001, even if formal certification is not in place. Productivity and innovation are essential in order to remain competitive.

If the business is not growing organically, or lacks scale, is it time to look at a merger or acquisition?

Top-performing businesses will grow in a recessionary environment, whether through sustainable growth or acquisition. Successful businesses will not hit the pause button.

Understanding The Need For Financial Reports

Before going further, it is important to understand the need for accurate and timely reporting of your financial performance. It should be business rule number one, but for many organizations this is where finding hidden profits begins.

When setting budgets, it is critical to have a business plan, usually up to five years, together with an annual budget that covers: profit and loss statement, balance sheet, cash forecast



Many organizations cut marketing budgets at the first sign of an economic downturn, but this is exactly the time to promote your product and services.

statement, and key performance indicators (KPIs). By creating a business plan, establishing a budget and introducing KPIs, you will give your board and management teams the tools they need to measure how well profitability initiatives are working.

There are many different financial reporting definitions for operating a business, but the basic ones to understand include:

Gross Sales: Total sales achieved from products and services.

Cost of Goods: Cost of procuring and adding value to the products and services sold.

Gross Profit: Gross Sales less Cost of Goods.

Gross Margin: Gross Profit expressed as a percentage of Gross Sales.

Operating Costs: Direct cost of manufacturing, assembling and distributing goods and services.

Overhead Costs: Indirect costs associated with corporate, finance and administration.

EBITDA: Earnings Before Interest, Taxes, Depreciation & Amortization.

EBIT: EBITDA less depreciation and amortization.

Net Profit Before Tax: EBIT less financing expenses.

Tax Expense: Net Profit Before Tax less various accelerated tax deductions for expenditure, such as research and development expenses.

Net Profit After Tax: Profit available for distribution to shareholders.

Earnings Per Share: Net Profit After Tax divided by the number of shares held in the company.

Once all the key stakeholders are speaking the same language, you can confidently move forward and find the hidden profit opportunities within the organization.

Where To Find The Hidden Profits

Now the planning stage of finding new profit opportunities has been completed, let's get into the detail. Based on years of experience in helping clients, the author believes the key initiatives to finding hidden profits come from four areas: Revenue Increases; Internal Cost Reduction; Supply Chain Optimization and Working Capital Funding.

Your board and senior management will need to understand these key drivers and identify initiatives that will deliver sustainable profit improvement. It is recommended that this program begins by benchmarking the organization's performance against its competitors, identifying the best-practice processes and prioritizing initiatives that have the greatest impact on profitability.

Another important consideration is whether the business culture is aligned to improving profits, and it has been found to be critical to nominate 'profit champions' who have the sponsorship of the Chief Executive and support from the board.

Revenue Increases

Organizations normally treat revenue as a priority, and it is no different when looking for hidden profits. The following initiatives are given in no particular order and can be implemented without the need for significant cash resources.

• Price Reviews

When was your last price increase for products and services? In most cases, we find prices have not been adjusted for several years. Organizations should issue a new price list at least once a year, with an explanation of why increases are necessary. If price increases are communicated professionally, clients will understand.

• Call Out And Delivery Fees

If you do not charge delivery or call-out fees, charging for these costs is an opportunity to increase revenue.

• Limit The Level Of Discounting

If a business with a 30% Gross Margin offers a 10% discount to customers, it will need the discount to generate a 50% increase in sales simply to maintain its Gross Profit. Is it worth it? Rather than discounting, consider promoting the value of your product or service.

• Increase The Average Spend From Existing Customers

By introducing a better incentive system for your sales staff it is possible to quickly increase the average spend from existing customers.

It is far more profitable to cross-sell or up-sell an existing customer than find a new one.

• Increase Marketing Activity

Many organizations cut marketing budgets at the first sign of an economic downturn, but this is exactly the time to promote your product and services. Depending on the market sector, spending 4–8% of revenue on marketing initiatives is recommended. Make sure you understand your business value proposition (price, value, quality) and ensure you are focused on the right potential customer. It is also recommended that marketing includes a strong online presence, as many buying decisions are now made based on information found on the Internet.

Other Initiatives To Consider

- **Innovate:** Add new products and remove older ones to keep your customers interested.
- **Watch the efforts being made to win new business.** If your win-to-bid ratio is less than one in three, your sales team may not be focused on the right potential customer base.
- **Go after new market sectors, or new geographical areas for your existing market sectors.**



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Internal Cost Reduction

When it comes to controlling costs, your Chief Financial Officer or Financial Controller is very important, especially when communicating the impact of poor cost-controls to the board and management teams. If the wrong person is in this critical role, your first step in controlling costs is replacing them.

Most recommendations to reduce costs fall into two areas: Operating Costs and Overhead Costs.

Operating Costs

• Team Structure

Over time a team structure can become bloated with underperforming staff, particularly if the organization has grown quickly, or if finding talented staff has been challenging and less-experienced staff have been hired to fill the gaps. In these situations, we develop an organization chart identifying the job descriptions and skills of the current team to identify where action can be taken. Issues to look for are the overall number of staff, level of staff turnover, average salary and revenue generated per operations. Obtain benchmarks to compare your business performance against that of your competitors.

• Mix Of Permanent And Casual Staff

Perhaps one of the biggest trends over the past decade has been the increased flexibility of workplace agreements. The trend towards using more casual staff and fewer full-time staff improves an organization's ability to respond quickly to increases and decreases in business activity. It is generally believed that your ability to remain competitive is substantially reduced if your business has not made this adjustment.

• Changing The Workplace Rules

Staff being asked to accept temporary reductions in pay or reduced work hours is another trend that has emerged from the GFC. Such steps should be undertaken with legal advice and with effective communication to staff on the need for these changes. If the long-term survival of a business is dependent on such a measure, staff will generally be willing to agree to the changes – as long as it is clearly shown to be a temporary step and not an opportunistic move to permanently lower staff costs.

• Productivity Enhancement Through Technology

It's often said that Australian businesses cannot compete with Chinese manufacturers in the production of goods. The clever use of

technology, however, can improve productivity and counterbalance low Chinese wages, so levelling the playing field.

• Other Initiatives To Consider:

- Increase individual product runs and gain a cost advantage from reduced set-up and change times between products.
- Remove all products with less than 5% Gross Margin from your range. It is difficult to maintain sustainable profitability below 5% Gross Margin unless there are substantial volume sales associated with such products.
- Claim government rebates and incentives.
- Lower tax expense through accelerated taxation rules applying to research and development expenditure.

Overhead Costs

• Property Lease Negotiations

The building housing your business, and its location, will generally be your largest cost after staff. Landlords have traditionally been reluctant to vary lease terms, but the GFC has seen landlords being more flexible in order to retain good businesses as long-term tenants. There are also new trends in office design that reflect the changing nature of the Australian workforce,

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The trend towards using more casual staff and fewer full-time staff improves an organization's ability to respond quickly to increases and decreases in business activity.

such as the ability to work from home. Ongoing dialogue with your landlord is encouraged, and negotiate for flexibility in your lease terms.

• Level Of Unnecessary Travel

Low-cost video conferencing substantially reduces the need for routine business travel and associated expenses.

• Outsourced Services

For many organizations, there is no longer a need to have staff available round the clock. It is often recommended you regularly send your accounting, legal, IT and marketing services to tender to lower overall costs. Even a partial outsource is likely to improve profitability levels.

• Number And Length Of Staff Meetings

Nothing impacts on staff productivity more than a culture of long meetings. Improve your productivity through a close analysis of the number and length of meetings staff attended each week. The importance of communication with and between staff is a given, but a poor meeting culture leads to lost productivity and lower profitability.

• Supply Chain Optimization

Obtain maximum efficiency and profitability from your business partners. They are not going to voluntarily advise you that you are paying too much! Challenge the status quo.

• Tender To Reduce The Cost Of Products

No matter how loyal a supplier is, it is in your interest to regularly test the costs associated with the supply of component parts, finished products or services. Regularly benchmark supplier's payment terms, product quality and warranty standards. A strong Chief Purchasing Officer who regularly challenges the supply-chain partners will have a significant positive impact on profitability.

• Stock Turn And Reorder Points

A supplier is always going to encourage you to carry as much inventory as possible. Use technology that helps effectively analyse stock-turnover and reorder-point optimization, thus retaining working capital, avoiding inventory obsolescence and still meeting regular customers' needs.

• Working Capital Funding

'Cash is King' is a more relevant statement than

ever before. The GFC has led to a survival-of-the-fittest mentality in the banking sector, where lending policies to SMEs have never been tougher. The costs of loans not only limit your growth opportunities, but are also a major factor in reducing profitability – and that is assuming funding is available in the first place. Trying to manage a business without a reliable cash forecast report is business suicide in this current environment; insist on a weekly/monthly cash-flow statement for the board and management.

• Debtor And Creditor Days Outstanding

We encourage every business to monitor the days outstanding for both debtors and creditors and to deal quickly with situations that go beyond regular terms. You are not a banker for your customers – and if you want to get the best supply-chain terms, you must pay your own creditors on regular terms.

• Debtor Finance Options

Debtor finance for invoices to customers is designed to assist in funding the trade cycle from order to payment, thereby avoiding a lack of working capital and the higher interest expenses associated with other funding options.

• Debt Restructure And Refinancing

This option is heavily dependent on the organization's ability to maintain a sustainable level of cash and includes accelerating the debt repayment program where appropriate. From a profitability viewpoint, avoid having surplus cash sitting in a low- or no-interest account while paying a higher rate of interest on an overdraft facility.

• Equity Raising For Planned Expansion

Depending on an organization's cash needs, it is possible to use short-term debt to fund restructuring and increase profitability. This business model has been successfully used by the private equity markets over the past decade: they acquire underperforming businesses relatively cheaply and then use debt to finance a turnaround program before selling the business on to new equity participants for expansion. The relisting of the Myer retail group is a recent example in Australia. It is a model that can also be applied by SMEs and can improve

profitability over a two- to five-year timeframe, but it does involve risks – particularly in the current economic environment.

Summary

In the past, many business cycles have been observed, and the recent GFC is just another one, in the sense that it has highlighted the need to refocus on business basics as a way to improve profitability.

For most companies, the business environment is no longer a 'friendly place' where you can simply set next year's budget by raising revenue 10%, expenses 5% and declaring an earnings increase of 20%. For many board and management teams, retaining clients is more of a challenge than at any time in the past decade. Customers have a choice as to where they purchase and are no longer willing to accept regular price increases. This is leading to a rethink in many organizations about the fundamentals of what made the business successful in the first place and what it will take to achieve sustainable long-term profitability.

When revenue growth slows, adapting and searching out hidden profits from your existing business is a highly effective way of staying ahead of your competitors. Organizations that maximize and control their business environment will be the winners in 2010. **ABS**

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John has more than thirty years of professional and commercial experience. He has a successful track-record in managing start-up operations and small- to medium-sized national and international companies, in industries as diverse as advertising, commercial property, IT software, government, manufacturing, mining, retail and television. John's commercial experience, from both investment and management perspectives, covers a broad range of disciplines, including management, operations, sales, marketing and finance. John can be contacted at www.lindfieldpartners.com.au.