BUSINESSES DON'T COME WITH SAT NAV

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HOW CAN YOU HELP STEER YOUR BUSINESS ALONG THE RIGHT ROAD IN RECESSIONARY TIMES? DANNY DARTNAILL GIVES A DRIVING LESSON

You're driving through Cornwall, searching for the holiday cottage you booked on the internet. You thought you were on the right road but now you're not so sure. You doggedly insist, however, that this must be the right way. Three villages further on and your resolve waivers, but just to be sure you give it a couple more miles. Five minutes later you agree you have taken a wrong turning and try to find a suitable place to turn around. By the time you do, you are 15 miles out of your way, fuel reserves are low, the children are fighting in the back and you wished you were back in the office!

From the point of view of your personal life, this may seem a fairly familiar story with minor consequences – wasted time, additional fuel costs and frayed tempers. But if similar behaviours are exhibited in a business scenario, the results could be far more serious.

The key to not getting lost is to continually monitor where you are and where you are going. In business terms this means reviewing trading performance and strategic direction regularly. When driving we have become increasingly reliant upon satellite navigation devices, which plan our routes, estimate arrival times and, most importantly, tell us how to get back onto the right road when we are lost. But management doesn't have that luxury when it comes to running a business and taking a wrong turning or refusing to accept that you are lost can have disastrous consequences – particularly in the current economic climate.

FINANCIAL MOT

Quality management information is key to successfully monitoring a business's performance. It should be accurate, prepared and circulated on a timely basis, and, most importantly, contain the information that the management team needs to effectively run the business. Frequently, management accounts are prepared on the same basis for years with little or no variation and often weeks after the end of the period to which they relate. Consider revamping your management information by:

- Assessing what the key performance indicators of your business are – both financial and non financial;
- Engaging with non-financial members of the management team to identify their needs. Not all users of the accounts will be trained accountants so find out what works for them currently and what doesn't;
- Reviewing the existing preparation process. Could some key performance indicators be circulated weekly (ie, high level sales figures)?
- Making it easy for the reader to extract the key issues quickly. A one-page summary highlighting material variances is invaluable, particularly where there are other stakeholders who do not live the business day to day.

OILING THE WHEELS

In conjunction with meaningful management information, a robust set of financial projections are a fundamental tool when managing a business. The purpose of projections is to enable management to understand the impact of their strategies as well as to provide a yardstick for current performance.

The projections should include an annual budget and a short-term cashflow forecast (typically 12 weeks rolling), both of which should be updated regularly. The short- term cashflow forecast is particularly important when headroom in the business's banking facilities is limited as, unlike longer term forecasts, it takes into consideration mid-month funding requirements.

Simplicity is best when it comes to financial models. The larger and more cumbersome they are, the more difficult it is to keep them updated and the more likely it becomes that errors will creep in. Although there are software packages on the market specifically designed for this purpose, a selfprepared spreadsheet is often sufficient.

By closely monitoring performance against an agreed set of projections, a management team can identify trends and act accordingly. In the current economic climate, early action to arrest a decline in a business' health could be critical.

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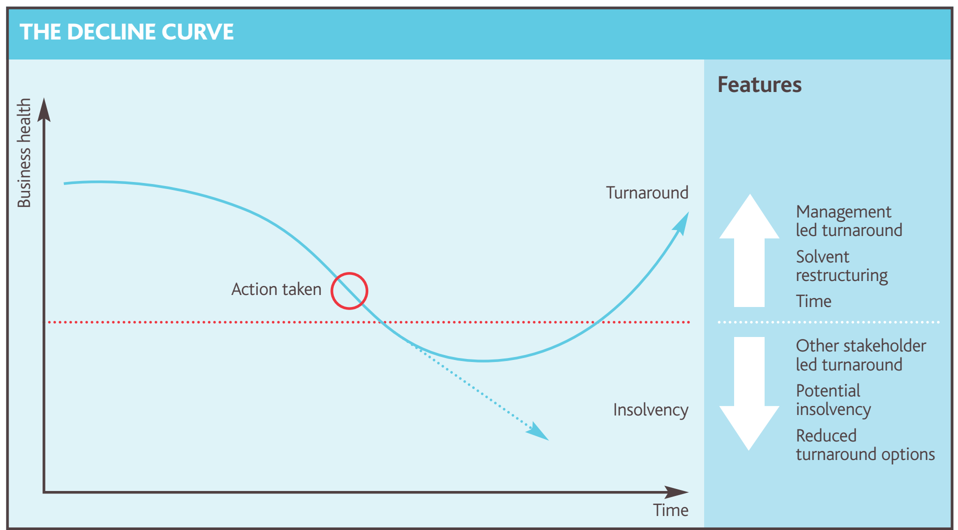
POTHOLES AHEAD

The decline curve has been used for many years in a number of iterations. The chart below highlights how a business's health, measured in profitability or cashflow terms, can deteriorate over time. The graph has two important features that are worth noting:

- Firstly, even after action is taken to address major issues, profitability and the cash position are likely to deteriorate further before things begin to improve (effectively your braking distance). For example, redundancies will result in longer-term cost savings but have an immediate adverse cash impact. Alternatively renegotiating contracts with major suppliers might improve the gross margin but these negotiations will take time and their existing invoices will need to be settled before more favourable contract terms apply.
- Secondly, the lower down the decline curve a business travels, the fewer turnaround options it will have, primarily due to the fact that cash headroom is likely to have fallen. This means the timeframe to effect a turnaround may be shortened and further investment could be needed to fund the proposals. (See graph)



CRASH PREVENTION

So what should a management team do if trading performance continues to decline? If trading results continue to track below expectations then management should:

- Investigate and fully understand the reasons behind the underperformance, drill down into the numbers that exhibit the greatest variances and identify what is going wrong.
- Assess what the impact is going to be on the business's finances if trading performance doesn't pick up. In particular, revise your short term cashflow forecasts to see what level of headroom you will have with your existing bank facilities and if you are going to breach financial covenants.
- Stress-test the numbers. What if things get worse? How bad will they need to get before the business runs out of cash? If more cash is needed then where will it come from?
- Consider contingency plans in case the worst does happen. Where can cost be cut out of the business? Can an underperforming subsidiary be disposed of via an accelerated M&A process?
- Talk to the business' advisors, who will have people experienced in dealing with these situations.

Remember from the decline curve above that things may well get worse before any changes begin to make a positive impact so timing is important. If things are going to be tight (particularly with regards to working capital facilities or financial covenants) then you should engage with your bankers sooner rather than later. Generally bankers dislike surprises, particularly if it means they might need to provide additional facilities at short notice.

Management shouldn't shy away from engaging with their bankers, especially if the news is not good. In fact, early engagement highlights that management is 'on the ball' and is being proactive in relation to the problems facing the business. The key, however, is to engage only when you are prepared. The bank will want to understand the issues facing the business, what the impact of those issues is likely to be and how management proposes to address them.

DRIVE CAREFULLY

Since businesses don't come with sat-nav, it's up to management to ensure that they don't get lost. Continual monitoring of financial performance and strategic direction coupled with a willingness to admit early that things are offtrack are both critical, particularly when the roads are more treacherous than they have been for a long while.

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