Is your business a going concern without you?

Most small to medium enterprises are highly dependent on their owners for survival. **Cecilia Farrow** has timely advice on how to protect your business from human capital risk.

As the owner of a small to medium business you would probably not be surprised by the findings of research published by Massey University's SME Research Centre in 2004.

Owners of New Zealand firms do not regard their business and personal 'lives' as separate – they recognize the interrelationships between business and leisure, and work and family.

This understanding was derived from the fact that when business owners were asked to identify 'key events or milestones' that had affected the firm's development, in addition to identifying the external factors and business milestones, many also identified events that the researchers coined non-business events which primarily were personal issues such as health problems, divorce and death.

Research data supports the proposition that most small to medium enterprises are highly dependent on the business owner/s for success and in many cases, survival.

A 2007 paper highlighted that 62 percent of business owners believed that the firm relied heavily on them and ACC reported in May 2008 that more than 70 percent of self-employed businesses that close down do so, at least in part, because of serious injury. 43 percent of those businesses had been operating for more than ten years!

Bad luck, bad management, whatever your belief, untimely death or disablement can have catastrophic effects and is arguably the greatest risk your business faces in terms of impact. The close interrelationship between your business and your personal life means that this risk extends to your lifestyle and wealth.

The current external economic factors increase the risk factors. Longer cash cycles, higher costs of debt servicing and lower economic activity weaken the solvency position of a business and therefore its ability to withstand shocks.

The tolerance of financiers and lenders to default on loan repayments is lower, increasing the risk of the call on personal guarantees – and access to capital is harder as lending criteria become stricter.

Richard Wiseman explains four secrets to success in his book The Luck Factor. His fourth secret is 'imagine what might happen and take control of the bad situations so that you achieve a good outcome'.

As entrepreneurs and business owners you live with risk every day. Fortunately risk has its upsides – good things happen. But risk also has its downsides and if we followed Wiseman's advice then we would, as part of striving for success, from time to time contemplate what might happen if bad things happened and put strategies in place to manage the result we want.

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At the risk of sounding corny, let's imagine that yesterday you suffered a serious health event. The prognosis is that you will be off work for six to 12 months.

Visualise your 2007-2008 end of year financials as they are today and see the key financial performance lines, Revenue, Cost of Goods Sold, Gross Margin, Operating Expenses and Nett Profit – and importantly the income that you as the business owner have had access to for your lifestyle.

Keeping in mind those core numbers, project forward six months on from your health event and imagine how things might have changed.

As a guide, a fundamental risk management principle is that you use worst case scenario planning first and then determine the acceptable or survivable position.

Firstly, think about your relationship to each of those financial numbers. What is it that you do on a day by day basis that relates to them?

In my experience of consulting to private enterprises for 12 years, the business owner almost always has a positive correlation to all of them, so therefore the business owner's absence has a serious negative financial effect.

Revenue is the life blood of any business. How is it generated in your business? Who holds the key to the customer relationships or manages those who do? What percentage could you lose and over what time frame? How will any plans you have for growth be affected?

As revenue falls then cost of goods sold may also reduce proportionately. But it's not always a straight line. What are the components of the cost of sales that may actually increase as a proportion of your revenue? If the quantity of inputs you order reduce will you lose volume discounts? Will the cost of wages, perhaps through overtime, increase? Could wastage and shrinkage increase, thereby increasing the cost of the inputs against your outputs?

So how does your Gross Margin look now?

If your business can survive the first few months without you, and the prognosis is you are likely to be back to work in the next six months, the chances are you won't cut your operating expenses unless you are forced to. So, you can count on the business having to meet its current costs of operation.

"If you are the driver within your business, you won't do yourself, your employees or your customers any favours by being humble about your importance when you are in your risk assessment process."

But now imagine the steps you might take to help manage the business through until you get back. Would you lean on your accountant to help manage the financials and give advice? What would that cost you on a monthly basis? Do you imagine you would engage a consultant to manage in the interim? What are the costs of that? Would you increase the responsibilities of some of your team members and increase their salaries to compensate? Could you recruit a replacement? How does the salary you pay yourself compare to the market rates you might need to pay and what other benefits would you have to provide?

The reality is that for most small to medium enterprises the business expenses increase.

A reduction in Gross Margin and an increase in costs can only result in one outcome – a reduction in profit.

Is your business still a going concern or are you now looking down the barrel of a fire sale?

In the meantime, how has your personal lifestyle had to change to cope with the loss of access to cash?

If the worst case scenario looks bleak you have probably thrown your hands up in despair by now and are saying to yourself, 'I'd just shut the doors and walk away'.

But there is one more thing I want you to visualize.

In your statement of Financial Position see the Liabilities the business owes. Tick the ones that you have personal guarantees over, but don't stop there. Visualise again your business expenses and tick the ones in there where you also have personal commitments. Perhaps the lease, the hire purchase on equipment, the finance lease vehicle. There may be others.

If the cash flow of your business is impaired, which of the business debts may be at risk of default and which of your personal assets may be called upon to repay the obligations?

Many business owners tell me they don't own a thing as it's all in a trust, forgetting that the personal guarantee was required to be signed by the trustees as well. Trusts are rarely the safe haven from lenders that business owners have been led to believe.

Now back to Richard Wiseman. How do you take control of this situation today so that you are prepared for any bad situation and can manage the outcome to give you the best potential result?

Firstly, do the reality check. If you are the driver within your business, you won't do yourself, your employees or your customers any favours by being humble about your importance when you are in your risk assessment process.

Secondly, plan to manage the risks you can. How can you reduce the dependence on you or someone else vital to your business through systems, documentation, empowerment, leverage and succession planning?

And lastly, work out the risks you can't manage. Seek advice on how you can transfer those risks so that you can maximize the upside but are protected from the downside, and so that, no matter what happens, you can make the best of it.

Cecilia Farrow is managing director of Triplejump – helping entrepreneurs develop and implement strategies to protect their wealth against human capital risk. www.triplejump.co.nz