

Module 1 - Financial Objectives & Management

Topic 2 - Budgeting & The GAP Analysis

Overview

This process allows business owners to establish and understand the gap between required/desired sales and current sales.

It's important to consider what profit you need from your business to ensure you can achieve the (personal) financial position you are striving for in the future.

You can treat your business as a "tool" to achieve your living and wealth needs.

It's important to remember that the return on your business investment comes over & above your 'living' income each year. Your living income reflects your daily activity and is therefore excluded from any return on investment (ROI).

So a business has to generate not just each person's living wage, but also a surplus to build wealth. If a business cannot post a surplus after owners wage, it might be hard to substantiate goodwill to a potential purchaser.

Remember that wealth is your business surplus 'after tax' each year.

Objective

At the conclusion of this module you should:

1. Understand the importance of completing a Gap analysis.
2. Know how to calculate your future wealth requirement and how to involve your accountant when necessary.
3. Be able to calculate your sales gap - that is the gap between required sales (based on personal wealth goals) and actual sales.

The Power Of Margin

The higher your margin, the less required sales you will need.

This is because margin reflects the profit on each sale after buying the product. It leaves more money to cover other business costs. Therefore less sales are required if margins are rising.

Conversely, the lower your margin, the more sales you'll have to make.

An obvious metaphor here is a super market. Their margin is relatively low, so must make up for this through huge sales volume.

Jewelers have far superior margins, but often struggle with sales volume or stock-turn.

So give margin away (discount) at your peril, for the consequence is far greater volume of sales to replace the margin lost and preserve ROI.

Strategy

The Gap Calculation can only be completed once required sales are known.

In order to determine required sales you require 4 components. These are listed below.

- a) Retirement Premium (click on attached link) Note: The links will contain PDF's or Forms
- (b) Personal Exertion component
- (c) Return on Investment (ROI)
- (d) Overheads (operating expenses)

Four Components

1) Retirement Premium

Background:

Do you work to live or live to work? For those people who work to live, this topic is for you.

If you live to work, keep healthy to enable you to work a long time as retirement is not something you would seriously contemplate right now.

Setting a retirement/exit target date is not something to be taken lightly or done quickly.

That date becomes a 'stake in the ground' that allows further calculations to be completed. The date set is private and can be modified if required.

When determining your personal wealth goals, you need to make assumptions about your future lifestyle needs and life expectancy.

We urge clients to take specialist financial planning advice in this area.

To determine your required annual sales goals, consider your target requirement date and your personal wealth goal. Your business now has a finite number of years to produce that wealth.

Exit can come in three ways.

1. A closing down sale.
2. Sale of your business to a new investor.
3. Sale of your business to a staff member(s).

Options 2 and 3 are usually preferable to simply closing down but require time and planning to build systems within the business if you are to maximize your selling price.

Buyers will not pay goodwill for systems they cannot see.

Action Plan:

1. Determine required wealth.
2. Set retirement/exit date.
3. Work out what your sales need to be each year up to your exit date.

2) Personal Exertion Component

Background:

Your personal work effort each week (exertion) reflects your living wage. It is to be consumed and does not form part of your wealth calculation. However any superannuation plan arising from savings (ex living wage) are included in your wealth.

Our template asks what your competitor might pay you to manage their store? We are trying to establish what you would earn with your skills/experience when running another persons store. This is to ensure your salary is based on strictly commercial terms.

If you have to work 50 - 60 hours per week to complete your role, please add the kind of premium over and above your salary that you'd expect if you were an employee. The business must pay for the hours worked to create the result.

Action Plan:

1. Complete Personal Exertion (PE) template (link).

3) Return on Investment

Background:

Putting a figure on a 'required return' is as much an art as a science.

Please seek help from your professional advisers (accountant) in this area.

Each jeweler's return will be unique to their specific financial circumstances.

Action Plan:

1. Determine the investment you have made in your business (e.g \$400k).

This is found in your business balance sheet & includes your capital & current account. If you have trouble with this please seek advice from your accountant. In our opinion, this figure should also include money not paid to you over time eg if your personal exertion wage is \$60k and your business has only been paying you \$40k, it owes you \$20k for each year you have short paid yourself.

2. Ascribe a financial return that warrants your business risk (e.g. 20%).

a) What is the 'risk free rate', i.e. the rate any bank would pay you for having your funds on deposit with them.

b) What is the 'risk' premium for being in business? Consider general small business risk, the fact your funds cannot easily be withdrawn (negotiability), and specific industry risk ... this is often in the region of 20%.

If your business return and remaining anticipated years in business will not derive sufficient funds to retire on, you may need to ask more from your business through increased sales.

4) - Overheads

Background:

In this context, overheads are all costs below your gross margin line.

As your gross margin (profit) is profit after the cost of the item only, overheads are simply everything else. The list would include wages, rent, power, bank fees etc. Basically everything in your Profit & Loss list (excluding product and your PE because this has already been taken into account in 2) above).

Action Plan:

1. Identify overhead costs from financial accounts.

The Gap Calculation:

Add totals A, B, C & D together using the Forms provided.

Divide the above total by your gross margin % and you have required sales.

Now deduct actual sales from required sales and your shortfall (GAP) is established.

Congratulations